Essays by Foreign Economists

ESSAYS BY FOREIGN ECONOMISTS

FORUM OF FREE ENTERPRISE
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Contents

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MYTHS THAT KEEP PEOPLE HUNGRY

By

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Some time ago, my wife and I spent a year travelling through Eastern Europe, the Middle East, and the Far East. In country after country we were deeply impressed by the striking contrast between the facts, as they appeared to us, and the ideas about the facts held by intellectuals.

Wherever we found any large element of individual freedom, some beauty in the ordinary life of the ordinary man, some measure of real progress in the material comforts at his disposal, and a live hope of further progress in the future—there we also found that the private market was the main device being used to organise economic activity. Wherever the private market was largely suppressed and the state undertook to control in detail the economic activities of its citizens (wherever, that is, detailed central economic planning reigned)—there the ordinary man was in political fetters, had a low standard of living, and was largely bereft of any conception of controlling his own destiny. The state might prosper and accomplish mighty material works. Privileged classes might enjoy a full measure of material comforts. But the ordinary man was an instrument to be used for the state's purpose, receiving no more than necessary to keep him docile and reasonably productive.

By contrast, the intellectuals everywhere took it for granted that capitalism and the market were devices for exploiting the masses, while central economic planning was the wave of the future that would set their countries on the road to rapid economic progress. I shall not soon forget the tongue-lashing I received from a prominent, highly successful, and extremely literate Indian manufacturer when I made remarks that he correctly interpreted as criticism of India's detailed central planning. Or the numerous discussions with professors at government-supported universities in India, where I was told again and again that in a country as poor as India it was essential for the government to control imports, domestic production, and the allocation of investment in order to assure that *social* priorities and not the market demand for luxuries dominated. Many of these discussions took place in comfortable university guest-houses, or relatively luxurious seminar rooms or lounges well shielded from the nearby hovels where the common people live. One even took place in the magnificent Ashoka Hotel in New Delhi, a showplace built by the government. Yet not once was any question raised about the appropriateness of the "social priorities" reflected in the allocation of governmental funds for these amenities.

I remember, also, the attitude of an audience at the University of Malaya in Kuala Lumpur. They listened politely, though with clear signs of rising hostility, as I expounded the merits of the market and the demerits of central planning for underdeveloped countries. The one remark that brought down the house was by the Malay chairman—the head of the economics department of the university. India's current difficulties, he instructed me, were not the result of central planning but rather of the suppression of India by colonialism (this nearly two decades after Indian independence).

A few examples show how clear the facts are. East and West Germany provide almost a controlled scientific experiment. Here are people of the same blood, the same civilization, the same level of technical skill and knowledge, torn asunder by the accidents of warfare. On the one side of the frontier, communism, tyranny, and misery; on the other, capitalism, freedom, and affluence.

Even two communist countries, Russia and Yugoslavia, offer a similar contrast. Russia is far more closely controlled from the centre; private property and a moderately free market have almost no scope. In agriculture only 3 per cent of the cultivated area is in private plots whose produce the owners are free to market privately—though this 3 per cent produces one-third of the total agricultural output of the Soviet Union. In industry there is no legal scope at all for private activity, though apparently there is substantial blackmarket activity. In Yugoslavia, on the other hand, the great bulk of agricultural land is privately owned, there are many private handicrafts, and a deliberate attempt has been made to decentralize industry. Yugoslavia is far from free and its ordinary people are far from affluent by Western standards. Yet it strikes the traveller as a paradise in both respects compared with Russia.

As it happened, we went from Russia directly to Yugoslavia, and both our departure from Russia and our arrival in Yugoslavia emphasized the contrast. On our way to the airport in Moscow, we had an Intourist guide assigned to us, as we had at every arrival and departure in Russia. This one turned out to be a young man who was in his final year of studies in American and English literature at the university. After desultory discussion of authors, I asked him what he was going to do after he finished school. "I do not know," he replied; "they haven't decided yet where I can be most useful"—no annoyance at having his career decided for him, simply a matter-of-fact statement. Three key questions were asked us as we went though the formalities for embarkation: "Are you taking any papers or letters out for any Russian?" "Do you have relatives in Russia?" "Did you visit anyone except as arranged by Intourist?" Having truthfully answered no, we were permitted to embark on a plane headed for Accra via Belgrade and carrying mostly Ghanaians returning home after an extended stay in Russia for military training. (To judge by the unrestrained comments of our seatmates, whatever the stay might have added to the military effectiveness of the Ghanaians, it had certainly inspired strong hostility toward the Russians and a heightened admiration of the West).

When we landed in Belgrade, questions by the authorities were strictly perfunctory. What surprised us even more, after our Russian experience, was the absence of any governmental official to meet and shepherd us. We were left on our own, much to our great delight. Without difficulty we were able to wangle, for a modest side payment, a ride into town on the one vehicle that was going there. The dinars for the payment were advanced to us at the hotel where we had privately made reservations. (In Russia, we had been required to pay in full in advance and did not know what hotel we were to stay in until informed by Intourist on arrival).

In the middle east, Israel and Egypt offer the same contrast as West and East Germany; in the Far East, Malaya, Singapore, Thailand, Formosa, Hong Kong, and Japan—all relying primarily on free markets—are thriving and their people full of hope, a far call from India, Cambodia, Indonesia, and Communist China—all relying heavily on central planning.

We were struck most forcibly by the contrast between facts and ideas in Malaysia. This country is a testimonial to the potentialities of competitive capitalism. Singapore, which was still part of Malaysia when we were there, was built on free trade. It has a vigorous industry and the standard of living of the ordinary Chinese or Malay citizen is many times higher than in neighbouring Indonesia or nearby India. Malaya itself was mostly an unsettled jungle three-quarters of a century ago. Today it is an attractive country with widespread cultivated areas. The standard of life of its citizens though somewhat lower than that of Singapore, is much higher than that of its other neighbours. Rubber and tin are its main export crops. Yet rubber is not even native to Malaya. The rubber tree was imported by private enterprises from South America; the tin mines were developed entirely by private concerns.

Malaysia, now independent, is in the process of deciding what economic policy to follow. Its own past offers one example. Its populous neighbours, Indonesia and India, offer another. Both have embraced widespread and detailed central planning, with results that are as depressing as they are clear. In Indonesia, the standard of living and the condition of the ordinary man has clearly deteriorated in the nearly two decades since independence—a major factor in the political turmoil. In India, the situation is only a little better.

Which example does Malaysia propose to follow? If the intellectuals have their way, as it appears they will, the new nation will follow India and Indonesia. The chairman of my meeting at the university, his colleagues, and the civil servants had no doubt that it was they who should control the direction of investment and development. A central bank had been established and a government development agency was already making long-range plans. A World Bank mission headed by Jacques Rueff of France, a liberal in the nineteenth century sense, had nonetheless bowed sufficiently to the temper of the times to recommend tariff protection; government development subsidies, and other measures of central planning. How clear it is that the world is ruled by ideas—not facts—and that ideas can for long periods live a life of their own, little affected by the facts.

Japan offers another striking example of the importance of ideas and the intellectual climate—less present-day Japan than its experience a century ago. We were much impressed by modern Japan: by the high level of income, its wide distribution, and its rapid growth; the aesthetic content of everyday life and common house-hold goods; the dignity of the Japanese people, and their courteous hospitality to the visitor.

A century ago, just prior to the Meiji restoration in 1868, the situation of Japan was very different. Japan had experienced centuries of deliberate and enforced isolation from the rest of the world. Though by no means completely stagnant, Japan's social and economic structure had altered little in that time, and it had fallen far behind the advanced Western countries in scientific knowledge and productive techniques.

There is a remarkable parallel between Japan just after the Meiji restoration and India after it achieved independence eight decades later in 1948. In both cases a major political change permitted drastic alteration in economic arrangements and the rigid class relations among men. In both cases the political change placed in power a group of able and patriotic men determined to convert prior economic stagnation into rapid economic progress—though for somewhat different objectives. In both cases, these events occurred in countries with ancient cultures and a high artistic and literary civilization. And in both cases the countries were technologically far behind the leading economic powers of the time. Both had an opportunity to make major economic gains by using techniques developed at great cost in the West.

There were also, of course, differences—mostly favouring India. India's physical resources are distinctly superior to Japan's except only for the sea around Japan, with its easy transportation and potential supply of food. Japan had been almost completely out of touch with the rest of the world; India has had extensive and widespread contact. The British, moreover, left India an excellent rail-road system, many factories, much physical equipment, and—even more important—functioning political institutions, numerous skilled administrators, and many men trained in modern industrial techniques. In my own contacts, the top Indian civil servants impressed me as man-for-man the ablest people in any civil service with which I have had experience—including the American. True, they are few and there is a tremendous gap between them and lower-level civil servants, but progress in any area has always depended on small numbers of people.

Finally, in the years since 1948, the rest of the world has made available to India—largely as gifts—an enormous volume of resources, roughly equal to a quarter of India's total capital formation. Japan had no comparable advantage. The closest parallel was the fortuitous failure of the European silk crops in the early years of the Meiji restoration, which enabled Japan to earn more foreign exchange by silk exports than she otherwise could have earned. Japan herself financed the training of Japanese abroad and the importation of foreigners with technical skills. During the whole of the first half-century after the Meiji restoration, Japan had not only no net grants from abroad, but not even any net capital import; she provided the whole of her own capital from domestic sources.

There is a widespread tendency to attribute India's difficulties to its social institutions, the character of its people, and the climatic conditions under which they live. Religious taboos, the caste system, a fatalistic philosophy are said to imprison the society in a straitjacket of tradition; the people are thought to be unenterprising and slothful. I find it impossible to accept any of these explanations. The Indians who have migrated to Africa or to Southeast Asia have in country after country formed a major part of the entrepreneurial class, and have often been the dynamic element initiating and promoting progress. In the Punjab, an industrial revolution is taking place in towns like Ludhiana with thousands of small and medium-size workshops, reproducing, or so it seemed to me, the experience of Manchester and Birmingham at the end of the eighteenth century. There is no shortage of enterprise, drive, or technical skill; on the contrary, there is a self-confident, strident capitalism bursting at the seams.

For a nation to progress, it is not necessary for every individual to be an enterprising, risk-taking economic man. The history of every developed nation shows that a tiny percentage of the community sets the pace, undertakes the path-breaking ventures, and coordinates the economic activity of hosts of others. Most people everywhere are hewers of wood and drawers of water. But their hewing of wood and drawing of water is made far more productive by the activities of the minority of industrial and commercial innovators, and the much larger but still small number of imitators. I have no doubt whatever that India has an adequate supply of potential entrepreneurs, both innovators and imitators. The appearance of sloth and lack of enterprise is surely a reflection of the absence of rewards for different behaviour, not a reason; the fatalistic philosophy is more likely an accommodation to stagnation, not a cause.

Many early foreign residents in Japan reported similar impressions. Wrote one: "Wealthy we do not think it (Japan) will ever become: the advantages conferred by Nature, with the exception of the climate, and the love of indolence and pleasure of the people themselves forbid it. The Japanese are a happy race, and being content with little are not likely to achieve much." Wrote another: "In this part of the world principles, established and recognised in the West, appear to lose whatever virtue and vitality they originally possessed and to tend fatally towards, weediness and corruption." They were wrong and so too, in my opinion, are those who are similarly pessimistic about India.

Although the circumstances of Japan in 1868 and India in 1948 were highly similar and the opportunities much the same, yet the outcome was vastly different. In Japan there was a thorough dismantling of the feudal structure, vast extention of social and economic opportunity, rapid economic growth, and widespread improvement in the lot of the ordinary man-though, unfortunately, nothing approaching real democracy in the political sphere. In India there was much lip service to the elimination of caste barriers yet shockingly little actual progress; differences in income and wealth between the few and the many have widened not narrowed; economic output *per capita* has been nearly stationary; and there has probably been an actual deterioration in the standard of life of the poorest third of the population. With all this has come a growing network of deadening and restrictive controls.

Why the difference in results? I believe the contrast between the two countries reflects primarily the difference in the techniques of economic organization adopted, though no doubt other factors played some part. Japan followed essentially a free-market policy, taking the Britain of its time as its model. True, the state intervened in many and diverse ways, and played a key role in the process of development. It subsidized the technical training of many Japanese and the importation of foreign experts, established pilot plants in many industries, and gave numerous subsidies.

Yet at no time did it ever try to control the total amount or direction of investment or the structure of output. It sold off most of its pilot plants to private firms within a few years. The state maintained a large interest only in shipbuilding and iron and steel, industries that it deemed necessary to build military power. It retained even these industries only because they were not attractive to private enterprise and required heavy government subsidies. These subsidies were a drain on Japanese resources. They impeded rather than stimulated Japanese economic progress. Finally, by international treaty, Japan was prohibited during the first three decades after the Meiji restoration from imposing tariffs higher than 5 per cent. This restriction was an unmitigated boon to Japan, though naturally it was resented at the time, and tariffs were imposed after the treaty prohibitions expired.

India has followed a very different policy. Its leaders, schooled in the doctrines of Fabian socialism and central planning, have regarded capitalism as synonymous with imperialism, to be avoided at all costs. They have taken Russia as their model and embarked on a series of five-year plans with detailed programmes of investment allocated between government and private firms and among industries. Certain areas of production are reserved to government. Tariffs, quotas, and subsidies to exports are widely used to shape foreign trade. When exchange difficulties arose, detailed and extensive exchange control was imposed. The Indian government controls wages and prices, prohibits private enterprises from building factories or making other investments without government permits, and levies taxes that are highly graduated on paper though largely evaded in practice.

Reliance on the market in Japan released hidden and unsuspected resources of energy and ingenuity, prevented vested interests from blocking change, and forced development to confirm to the harsh test of efficiency. Reliance on governmental controls in India frustrates initiative or diverts it into wasteful channels, protects vested interests from the forces of changes, and substitutes bureaucratic approval for market efficiency as the criterion of survival.

An instructive specific example is the different experience with home-made and factory-made textiles in the two countries. Both Japan and India had extensive production of textiles in the home at the outset of their development. In Japan home production of silk was for long little affected, but home spinning of cotton, and later, handloom weaving of cotton cloth, unable to meet the competition of foreign spun yarn and factory-made cloth, were all but wiped out. A Japanese factory industry developed, at first manufacturing only the coarsest and lowest-grade fabrics, but then moving on to higher and higher grades and ultimately becoming a major export industry. In India, hand-loom weaving was subsidized and guaranteed a market, allegedly to ease the transition to factory production. Factory production is growing gradually, yet there is no sign of end to the subsidy. Indeed, hand-loom production is now larger than it was when the subsidy was introduced. Had Japan followed a similar policy, it still would have an extensive home cotton-textile industry—and a drastically lower level of living.

The most dramatic illustration of the waste that has been created by substituting government for market control in India is automobile production. For some time now, the importing of both second-hand and new cars has been prohibited, supposedly to save foreign exchange by reducing "luxury" imports. Naturally the price of second-hand cars has skyrocketed. When I was in Bombay in 1963, a 1950 Buick—much like one I had sold in New Hamphshire a few months earlier for $ 22—was selling for $ 1,500. The government has licensed the production of new cars, mostly copies of foreign makes. Their manufacture is proceeding in uneconomical small runs and at extremely high cost. India, its government apparently believes, is too poor to use second-hand cars; it must have new ones. I estimated in 1963 that about one-tenth of total American aid was being absorbed in the extra cost to India of getting motor vehicle transportation by building new cars instead of importing used ones—a glaring example of the wastes of conspicuous production.

The tragedy of the industrial revolution in the Punjab lies in this same waste and misdirection. Businessman after businessman told me that one-quarter of his time was usually devoted to getting around governmental restrictions—price control, rationing, and so on. Even more important, the distortion of prices and costs through governmental interventions means that the businessman's energy and ability are being diverted towards doing the wrong things in the wrong ways.

Ironically, the men who took charge of Japan in 1867 were dedicated principally to strengthening the power and glory of their country. They attached no special value to individual freedom or political liberty; on the contrary, they believed in aristocracy and political control by an elite. Their political ideas were the basis for later tragic totalitarian excesses. The men who took charge of India in 1948 had very different ideas. They were ardently devoted to political freedom, personal liberty, and democracy. Their aim was not national power, but improvement in the economic conditions of the masses. Yet it was the Japanese leaders who adopted a liberal economic policy that led to the widening of opportunities for the masses and, during the early decades a great gain it their personal liberty. It was the Indian leaders who adopted a collectivist economic policy that hamstrings their people with restrictions and continues to undermine the large measure of individual freedom and political liberty encouraged by the British.

The difference in policies reflects faithfully the different intellectual climates of the two eras. In the mid-nineteenth century, liberalism (in its original, not its current American sense) was the dominant view. It was simply taken for granted that a modern economy should be conducted by free trade and private enterprise. It probably never occurred to the Japanese leaders to follow any other course. In the mid-twentieth century, collectivism was the dominant view. It was simply taken for granted a modern economy should be conducted by centralized control and five-year plans. It probably never occurred to the Indian leaders to follow any other course.

Ideas can for a time lead a life of their own, independent of reality. But sooner or later they must meet the test of evidence. It may be crucial for the fate of mankind that they do so soon.

We, who are fortunate enough to live in the West, take for granted the freedom and affluence we enjoy and regard them as the natural lot of mankind. They are not. They have been achieved only for brief intervals in the long history of mankind. At no time, and certainly not now, have they been achieved by more than a small fraction of the world's population. We have been generous in our material aid to the less fortunate; we have given them a fine set of aspirations and an example of a free and affluent society. But we have also transmitted a climate of opinion hostile to the market arrangements that appear to be a necessary condition for both freedom and affluence.

We have a sufficient margin of protection to survive such ideas for a long time. The less-developed nations do not. In their failure, they may destroy us as well. The continuing ascendency of such ideas may doom mankind to a renewed era of universal tyranny and misery.

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ECONOMIC DEMOCRACY

By

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Some fifteen years ago, there was a general feeling in India of confidence in the future. People felt inspired when the politicians spoke of those "sunlit plateaus of prosperity" only a short distance ahead. People were ready to tighten their belts and looked forward eagerly to the take-off into full employment, rising standards of living, and national self-reliance. But today there is widespread disillusion, and even despair. Centralised planning on a large scale has failed to achieve its objectives. Average living standards have not significantly improved. Unemployment and the foreign trade deficit have increased from year to year. And the goal of self reliance seems farther off now than ever before. In 1956, at the beginning of the Second Five Year Plan, India was still a net international creditor to the extent of over Rs. 700 crores, equivalent to more than one year's exports at that time. In 1968 India had become a net international *debtor* to the extent of well over Rs. 5,000 crores, equivalent to more than four years' exports at the post-devaluation level.

If we add to all this the recent inflation plus the severe industrial recession, the prevailing mood of doubt and pessimism is easy to understand. It is also understandable that the economic policies of the past two decades should now be subject to searching criticism. Already the mighty Planning Commission has been cut down in size and confined to advisory functions. The massive Fourth Plan has been put in cold storage for three years, perhaps as a preliminary to shelving this type of planning altogether. A fierce public debate has begun between those who want still more state control and direction of the economy and those who want a competitive market economy with free enterprise. Meanwhile the politicians are adopting "a pragmatic approach", which is a polite way of describing the present kaleidoscope of government decisions to control this and to decontrol that. India today is indeed standing at the crossroads of economic policy. And the signpost has been daubed with so much ideological tar that it is difficult to see which way to go!

One may well ask what is the relevance here of discussing a few ideas about economic democracy. The short answer to this is that we can never underestimate the power of ideas. Throughout history men have been prepared to give their lives for the sake of ideas. They have also been prepared to take the lives of others: Only a generation ago millions of people were systematically exterminated in Europe because of the racial ideas of the German national socialists. And today in China we have the extraordinary spectacle of how the lives of 700 million people can be completely subordinated to the ideas of one single man. Mao Tse-Tung.

Likewise, we can never underestimate the power of words which express ideas and which can also confuse or conceal them. For instance, over a year ago, in an attempt to regulate supplies of raw cotton to the textile industry, the Government of India issued the Cotton Control Order. This gave government agents the power to seize supplies of raw cotton at government-controlled prices—a process which was officially referred to as "requisitioning". Let us now compare this with the present emphasis on food "procurement." Government agents may still compel the farmer to hand over his produce at fixed prices but it does not sound so oppressive if we call this "procurement" instead of "requisitioning". Perhaps it does not matter politically if one offends a few cotton produces and traders but one can hardly afford to upset the entire farming community. So while we may "requisition" raw cotton, we only "procure" rice or wheat!

Let us now examine this word "democracy", which we may broadly define as "government by the people". We find it is generally used as a term of praise. Most people regard democracy as a good thing, as something we should all have more of. To call something democratic is to show that we approve of it, though this has not always been the case, particularly in earlier centuries. The result in this century has been a fierce scrum between opposing sides to get possession of the word and to apply it to such widely different systems of societies as those of the U.S.A. and the Soviet Union. And in the process the meaning of the word has been rather obscured.

It seems to me that this confusion can be largely removed if we distinguish clearly between two different concepts or ideas of democracy. These I shall describe as the "classical" and "liberal" concepts of democracy.

The classical concept of democracy is based on the traditional view that in all forms of government a particular person or group or class rules over society as whole. Thus "aristocracy" means rule by the nobility, "theocracy" means rule by the priests and "plutocracy" means rule by the wealthy. If the dominant group consists of technicians or scientists, we have "technocracy", and if the officials or administrators are in control we have "bureaucracy". But if political power passes into the hand of "the common people" then we get "democracy" in the classical sense where the unprivileged masses rule over the other groups or classes in society.

This concept of democracy goes back to ancient times and is found in the writings of Plato and Aristotle. The word "democracy" is in fact based on the Greek word "demos" meaning " the common people." Democracy in this sense is tied to the notion of class struggle and is not incompatible with dictatorship. It is in this sense that we may refer today to the "people's democracies" of China, the Soviet Union and East Europe. Democracy here is often defined as "the dictatorship of the proletariat", meaning (at least in theory) the rule by the proletariat over the bourgeoisie.

The liberal concept of democracy has emerged only in modern times, over the past two or three hundred years. It differs from all other ideas or theories of government by vesting political authority equally in every citizen. Government by the people does not mean government by the "common people" or proletariat but government by all the people, by everyone in society, regardless of any rank or class. The objective is self-rule, as opposed to all other forms of government where a specific group of people (whether a majority or not) rules over all the rest.

This is the kind of democracy which Lincoln defined as "government of the people by the people for the people." It asserts that there shall be no second class citizens in society. Everyone is equal before the law, including those who hold the highest government office. The institutional framework for this is a separate judicial system free from any political control. Likewise, everyone is given an equal share in making the law. The institutional framework for this includes full adult suffrage and periodic elections.

Democracy in this liberal sense is opposed to any kind of dictatorship or totalitarian rule. Its ideal is the mature self-governing individual. Majority rule is not the rule of a specific majority group or class but is a purely functional majority relating to specific issues at a particular time. This type of government must not oppress any individual or minority, for this is the condition on which all citizens agree to accept the majority decision. It is also the condition which makes it possible for any minority on one particular occasion to become the majority on another.

Accordingly, government or state power is made subject to certain strict limits. Indeed, the government is constitutionally bound to protect the basic rights of each individual to think and act as he pleases provided that he does not deny these rights to others. As a learned judge once put it, "Your rights end at the tip of my nose." These rights include liberty of speech and of political organisation. The institutional means for realising these rights is greatly improved by the development of independent newspapers free from state control.

It is this liberal concept of democracy which has been adopted by independent India and which inspires its Constitution. It is evidently well suited to Indian culture and traditions which emphasise, as Mahatma Gandhi always did, the value and dignity of the individual, the importance of voluntary action, and the tolerance of widely different customs and beliefs. The result has been, and continues to be, the greatest experiment in political democracy that the world has ever seen.

But what about economic democracy? How shall we govern ourselves, not as citizens but as producers and consumers? What kind of economic system is appropriate for a democratic society and for India in particular?

This was a favourite question of Nehru's. His answer (which was very different from Gandhi's) lay in a form of socialism based on centralised economic planning and the extension of government ownership and control throughout industry and commerce. The reasoning here is straightforward. Private ownership or control over business undertakings means that some people will be employed by others. To this extent they will not be their own masters and may be exploited by their employers. However, if all undertakings are owned or controlled by the state, which in turn is controlled by a democratically elected assembly, then all citizens will become their own economic masters.

This is the theory, but what is the result in practice? For India the process of introducing socialism began in earnest with the 1956 Industrial Policy Resolution and the Second Five Year Plan. It still continues, though in a hesitant and half-hearted manner, as for instance in the recent "social controls" over banking and general insurance.

The extent to which this process has gone is not generally realised. During the Second and Third Plans the paid-up capital of government companies rose from Rs. 66 crores to over Rs. 1,240 crores. This represents a rise from 6 % to 43% of the total paid-up capital in the corporate sector. If we take account of the increasing investment by government financial institutions and by the Life Insurance Corporation in non-government companies, it is probable that the Government of India already holds more than half the total capital invested in the corporate sector.

Nor does this take account of the still larger investment in government industrial and commercial undertakings outside the corporate sector. These include the ordnance factories and the largest undertaking of all, the Indian Railways. Whereas the nationalised railways of Britain, France, Belgium and other countries have been organised as a separate company or corporation, the Indian Railways continue to be run as a department of the Central Government.

Apart from capital invested government undertakings have been receiving large sums of public money in the form of grants or loans, sometimes free of interest and usually at subsidised rates. For example, the Union Budget for 1966|67 provided Rs. 244 crores for these loans and in practice this provision was exceeded by 50%. The total new loans made that year to government undertakings were more than three times the total new investment in their share capital. This total also exceeded the total government revenue from corporate taxation—revenue derived mainly from the generally more efficient non-government companies.

There is no doubt that this experiment in "economic democracy" has been extremely costly. Government undertakings have absorbed not only huge domestic resources but also the lion's share of foreign aid. As for the results, it is officially recognised that this massive investment in government undertakings has been extremely unproductive. Despite various subsidies, preferential treatment and monopoly privileges, these undertakings have given an average return of less than 1% on the capital employed as against the planned target of "not less than 11% to 12%". Indeed, if we include the current losses of the Indian Railways, the government-run undertakings as a whole constitute a net national liability.

Most of us would agree that India, with mass poverty and mounting foreign debts, cannot afford this enormous waste of productive assets. Yet the performance of government undertakings has shown little improvement despite the most searching inquiries by parliamentary committees. This has placed the Indian democratic socialist in a peculiar dilemma. Almost every scheme to improve the working of government undertakings has stressed the need to give greater independence and responsibility to the management. However, if this is done, what becomes of the so-called "social control" over these undertakings, as exercised by the people through Parliament? What does it mean to the ordinary citizen to say that he owns these enterprises when his power is confined to one vote every five years to elect an assembly which itself can do little to control the day-to-day working or even the long-term policy of these undertakings? Can this be described as economic democracy in any real or practical sense?

Of course, this is not the only type of socialist organisation which claims the coveted title of "economic democracy". In Yugoslavia, during the past few years, the power of the state to direct the economy has been drastically reduced in favour of a market economy. At the same time the ownership and control of business undertakings has been decentralised and placed in the hands of the respective workers in each unit.

This Yugoslav system seems to approach closer to the objective of self-government in economic affairs, at least as far as labour is concerned. The workers seem to have much better opportunities to influence the policy and day-to-day management of the undertakings in which they work than say, the workers employed to government undertakings in India. Profit-sharing systems also ensure that the Yugoslav workers share more directly in the benefits of efficient working. However, attempts to introduce this form of economic democracy in India have not been particularly successful. Several schemes for workers' participation in management have been tried, both in government and non-government undertakings, but have not inspired much enthusiasm either with labour or with management.

These problems of economic democracy can be solved if we go back to first principles. We have already seen how liberal democracy rejects the notion of class struggle and vests political authority equally in all citizens regardless of their rank, wealth or function in society. We have also seen how this authority is rooted in personal liberty and how it is exercised through periodic elections and the pressure of public opinion.

There is one further condition for liberal democracy. If the political authority of each citizen is to be a practical reality, he must be given a genuine choice when he casts his vote. Where only one political party is permitted to operate and only one list of candidates can stand for election, the individual citizen is clearly deprived of a proper political choice and hence of his authority. He becomes a pawn in the hands of the state and of the self-appointed leaders who claim to govern the country in his name. The reality of self-government is lost.

Here in India, however, the basic freedoms of thought, of self-expression and of political organisation have been firmly established. The voter has acquired a widening choice of candidates, parties and programmes from one general election to the next. And now that several non-Congress governments have come to power, we can expect the politicians to pay increasing attention to their constituents, both at election time and in between. In this way the central and state governments become more responsive to public opinion and every man can feel more certain that he is his own political master. Self-government becomes a matter of genuine experience for all. The quality of life, involving the dignity and self-respect of each citizen, is improved.

Let us now apply these thoughts to the economic life of each citizen. Let us also bear in mind the basic objective of all economic activity. This does not lie in any of those high-sounding phrases such as the "mobilisation of resources for development" or "the achievement of a surplus in the balance of payments." The objective of economic activity is no more and no less than human consumption.

Economics may in fact be defined as a systematic study of the ways in which people seek to satisfy their almost unlimited wants from the limited resources at their disposal.

Accordingly, just as the individual citizen is the object of political decisions, so the individual consumer may be regarded as the object of economic decisions. Again, just as political democracy regards the individual citizen as the ultimate authority, we might well expect an economic democracy to vest similar authority in the consumer. Let us push this comparison still further. If the consumer is to exercise real authority, if he is to influence decisions to invest, produce and sell, he must be given a genuine choice between different products and services. The suppliers must also be responsive to the wishes of the consumer.

What does this add up to in practice? What kind of economic system gives the consumer the maximum control over what shall be produced and sold? Quite evidently, the consumer has little or no choice when the only producer or trader is the state. Just as political self-government is a sham where only one party can put up candidates for election, so is economic self-government where there is only one supplier of goods and services.

On the other hand, if the market contains many independent producers and traders, each competing to sell more, the consumer can fully make his presence felt. We may therefore require a system of competitive free enterprise. Secondly, if the supplier is to know the wishes of the consumer, it is necessary for prices and profits to register promptly and correctly the ever-changing pattern of demand. To achieve this, a market system with freely moving prices is required. Thirdly, if supply is to respond properly to consumer demand, the suppliers must depend for their survival and success on getting the financial votes of the consumer. This means a system based squarely on the profit motive, with high rewards for success and with bankruptcy and oblivion for those who persistently fail to please the consumer.

Theoretically, we can have several state-owned units competing against each other and so providing alternatives to the consumer. But if each unit has a guaranteed life, and is not judged strictly by its profitability, it may still go out of its way to woo the consumer. The competition will be superficial only and the customer will still be powerless to influence the pattern of production.

This is a matter of everyday experience. When a consumer enters a shop or department store in a competitive market economy he can feel ten feet tall. The customer is always right and can expect good service. But in a state-controlled economy such as the U.S.S.R. the individual may spend much of his leisure time in queues. Likewise in India we have come to associate queues with government controls. It is generally at the shop which is state-owned or controlled that people must queue up for what they require, whether it is for rice or wristwatches.

So from the viewpoint of consumers we may conclude that the road to economic democracy lies through free enterprise in a market economy, i.e., in the opposite direction from centralised socialist planning. It further appears that genuine economic democracy, like political democracy, goes hand in hand with individual liberty. Just as we demand freedom of speech and organisation in the political sphere, so must we be free to engage in any economic activity. This means that we should be free to buy and sell, to spend or save, to invest in any business (whether agricultural, industrial or commercial), to work or not to work, to employ or to be employed, to change one's job and to travel as we please.

This claim to economic freedom springs from a belief in the intrinsic worth or sanctity of the individual, regardless of his contribution to society. No man has to justify his existence by what he does for others. Provided his existence is not directly anti-social, he has the fundamental right to live his life as he pleases and to go his own way. The same holds good for any group of individuals such as a club, a political or religious society, a business firm and so on.

This means, firstly, that a man is free to work or not to work. It means that a man, if he chooses, may withdraw himself from society and lead a life of solitude, abstinence and meditation. It means that the state should not assume the right to imprison beggars, gypsies, or hippies in corrective labour camps simply with a view to making them "useful members of society."

Secondly, it means that a man is free to choose the type of work he shall do and shall be free to change his mind. For example, considerable public resources may be invested in the training of doctors. No doubt this places each trainee under some moral obligation to continue with a medical career. But does it give society any right to prevent a trained doctor, if he wishes, from leaving his profession to become an artist or a yogi? Take any other example. What right has any government to decide that engineering will be given priority over poetry, or that driving a tractor is better than riding a racehorse? In Calcutta citizens would surely agree that collecting garbage is socially more important than collecting stamps or butterflies. But does this give us the right to abolish stamp collecting or to close down the business of professional stamp dealers as the Red Guards did in Peking?

This is not to say that people should not be useful to society, nor that society should not reward people according to the services they perform. It is simply to say that any service which they perform for others should be purely voluntary or should result from *impersonal* pressures such as the necessity to earn a living for oneself and one's family. No person or group of persons should assume the right to coerce people into serving others in the name of certain collectivist or totalitarian doctrines which regard society as more important than the individual.

We may, therefore, reject the traditional slogans of communism and socialism which require each individual to serve society according to his abilities. The truly democratic society does not demand "From each according to his abilities......" but rather "From each according to his own free will......".

Of course, freedom alone is not enough. There must also be real opportunities for choosing different kinds of work and for changing over. It is evident here that job-seekers have a much wider choice of employment in a free enterprise economy, where there are many independent employers competing against each other. Through union organisation, workers can also bargain for wages and conditions of work with the strongest employer—even with General Motors of the U.S.A., a company whose annual turnover of more than 20 billion dollars exceeds two thirds of the total national income of India. The opportunities to change one's job are also multiplied where there are many different employers in the market. And in a free enterprise economy every man has also the opportunity, if he has the initiative and ability, to start his own business by becoming self-employed or by employing other people.

Contrast this with the plight of the worker where all undertakings are owned or controlled by the state. Unions are relatively powerless to defend his interests for they are faced by an employer who wields political power and who claims to act always in the public interest. The ultimate right to strike may then be denied. Again, if the worker falls foul of the management in one state undertaking, he may be blacklisted for life throughout the economy. Where then could he turn to start life afresh? But in a free enterprise economy, as we have seen, he would still have many other opportunities.

Likewise, the free enterprise economy does not restrict the freedom to invest or to engage in any productive enterprise. This freedom, however, is severely restricted in communist countries. Even in the more liberal form of socialist organisation pioneered by Yugoslavia, the profits earned by a particular unit cannot be freely invested in another industry. To give a practical example, the workers of an engineering unit which is making huge profits can decide, if they wish, to build a luxury seaside guest house for use by themselves and their families. But although it may be unoccupied for long periods, the workers may not run it also as a hotel for tourists, as this would be equivalent to equity investment in another industry. According to Marxist theory, the engineering workers would then be exploiting the workers employed in the hotel business by taking away the profits earned on the investment. This would constitute the ultimate "revisionist" sin of converting a socialist economy right back to capitalism.

This brings us to the fascinating controversy over private property. As we have seen, both the socialist and the communist restrict the individual right to own productive resources, particularly land and equity capital. This restriction is generally imposed in the name of democracy and social equality. Yet there are many who hold the opposite view that the freedom to own and manage private property is a vital feature of democracy. In this view a man should be free to accumulate as much private property as he has the good fortune or ingenuity to acquire by legal means. This notion is a logical extension of the liberal concept of self-government—that a man may own and develop his own business, his own farm, his own mine or factory.

Of course, this implies a society in which some men may be employed by others. The employers can then exercise considerable power to govern the kind of work to be performed by others, what their wages and conditions of work shall be, and whether they should work at all in the business. In practice, however, this power of the private employer is subject to strict limits set by legislation for factory welfare, minimum wages, safety and so on. It may be further limited by the organisation of joint stock companies and by the organisation of labour into unions.

And ultimately the employee has the option of seeking employment elsewhere.

On the other hand, a society which forbids its members to own land or other productive assets and which prevents people from developing their own private business, imposes severe limits to human freedom and to individual ambition and enterprise. Such a society may lack originality, variety and adventure. And because it is less able to mobilise the personal initiative, enthusiasm and drive of its citizens, this type of society must condemn its members to generally lower standards of living.

This is not mere speculation. We have only to look at the tremendous gains in living standards made by the free enterprise economies of the U.S.A. and Japan. The same holds true for the developing countries of Asia. It is the free enterprise economies of Malaysia, Thailand, Taiwan and South Korea which have risen to the top of the Asian economic ladder while the centrally directed economies of India, Burma and Indonesia have remained at the bottom. Perhaps the most fantastic performance of all is that of Hong Kong where free enterprise has been combined boldly with free trade. It is not generally realised that Hong Kong's first textile mill was set up only in 1947 while her electronic manufacturing industries have been developed almost wholly in the 1960s. Yet, Hong Kong's textile exports are three times as big as India's if we exclude jute fabrics. Likewise, exports of Hong Kong's electrical products alone have now risen (without any subsidies) to double the entire engineering export from India as a whole.

Competitive free enterprise does in fact combine self-interest and voluntary action with the public interest in a most effective way. On the one hand, the business man is under constant pressure to improve his products and services. On the other, he must endeavour to reduce his costs of production and marketing and so economise in scarce productive resources.

Correspondingly, losses serve society by driving the less efficient producers or traders to make better use of the resources at their disposal. If the losses still continue, the inefficient go out of business and control of productive resources passes into the hands of the more efficient. In this way, the wasteful use of productive resources (in relation to consumer demand) is automatically checked and eliminated.

Somehow, it is difficult to believe that this automatic working or the market mechanism can be more efficient than the conscious direction of investment and production by central planning bodies. Yet this is undoubtedly the experience in practice. President J. F. Kennedy of the U.S.A. expressed this in the following words: "......the free market is not only a more efficient decision maker than even the wisest central planning body, but even more important, the free market keeps economic power widely dispersed. It is thus a vital underpinning of our democratic system."

We may recall here the wisdom of Mahatma Gandhi who regarded all forms of collectivism as a threat to the dignity and freedom of the individual. Gandhi did not fear economic power concentrated in private hands for he realised that such power is limited (as we have seen) and can be directed towards the common good. He feared more the concentration of economic power in the hands of the state, since the combination of political and economic power can lead to far greater violence and coercion of the individual. Owners of private property can therefore provide a valuable counterweight to offset power concentrated in the hands of the politician or the administrator.

We may. therefore, reject the view that Indian industry and commerce should be closely controlled and directed by the state. We may recognise that a system of free enterprise is more suited to the Indian temperament and traditions of land ownership, of the family business, of numerous artisans, small traders and cultivators and of enterprising business.

We may also recognise that the man who performs the greatest service in India today is the entrepreneur—the man who brings together money, materials, manpower and know-how to create new wealth and employment. It is this man, the business man, whether a farmer, manufacturer or trader, who is the real architect of economic democracy. It is he who increases the consumer's range of choice and compels his competitors to improve their performance in serving the consumer and in reducing costs. It is he who increases the investor's range of choice by competing in the money market for capital and credit. It is he who increases the range of job opportunities for us all by entering the market for skilled and unskilled labour, for office staff and for technical and managerial personnel.

This is not to say that the business man does all this purely from a sense of civic duty or a saintlike devotion to his fellow man. Indeed, why should we expect or want any such favours? Adam Smith summed this up admirably some two hundred years ago. In his famous treatise on "The Wealth of Nations", he wrote: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their own advantages. Nobody but a beggar chooses to depend chiefly upon the benevolence of his fellow citizens."

It follows that if we wish to increase our range of choice in the economic sphere, whether we are spending or saving or earning our living, and so increase our power to influence our economic environment, we should give the business man greater freedom to invest, produce and sell and stronger incentives to do so. We should remove the barriers to enterprise which have resulted from the Industrial Policy Resolution of 1956, the Industries (Development and Regulation) Act, the Essential Commodities Control Act, and so on. We should not fall prey to those ideologies which appeal to human envy but should recognise clearly the importance of profits as a reward for business enterprise and efficiency.

We may then appreciate more the service which the business man renders to society and the many risks which he must face. This was delightfully expressed in a notice published recently by the U.S. National Chamber of Commerce in Washington. It is entitled "The Risky Life" and it opens with a reference to the elections in the U.S.A. It reads as follows:

> "With general elections less than a year away, the politician faces growing uncertainty and risk.
>
> "Will the people—the consumers—buy what he's selling? Will he profit from his endeavours by being voted into office again?
>
> "Of course, the politician has to meet the test of the political marketplace only on election day—not every day, every year. A politician can simply declare that something is for the public good, unlike a businessman who has to prove it. And a politician spends and invests other people's money, not his own.
>
> "Come to think of it, there's another line of work where the risks come even faster and thicker — in business."

As for the businessman in India, he must face several other difficulties. During the period of centralised planning, he has become virtually a prisoner in the dock. His movements are severely restricted and he is accused of all manner of evils. If he employs labour he is branded as an exploiter and a bloodsucker. If he invests in equity, he is called a gambler or a parasite. If he engages in any form of trade, he is liable to be labelled as a profiteer, if not as a blackmarketeer. If he shows any sign of affluence he will surely be referred to as a tax evader, however honest he may be. And if he is honest, he will be taxed at rates which would be regarded as penal in almost every other country in the world. As if this were not enough, he may also be accused of corruption in his private life. The average popular film, for example, frequently portrays the businessman as a grotesque figure who apes foreign dress and manners, who neglects his family and who spends his leisure in nightclubs and the like.

The irony of the situation is that the prisoner may often have a much better record of public service than that of his accusers. But the prisoner has been so browbeaten or brainwashed that he has neither the confidence nor the courage to lay the blame where it is due. And far too often he has tried to compromise, to seek relief by the backdoor, instead of acquitting himself squarely before the bar of public opinion.

Fortunately a bolder spirit now seems to be emerging from the business community. Perhaps it is due in part to the trials of the current economic recession. As this spirit grows it will strengthen the movement for a more liberal economic policy. The ordinary business man will have the moral fibre to stop asking for favours from the government or for one-way promises of loyalty or productivity from labour. He may cease to ask only for protection and subsidies and will demand instead that taxes levied on his business shall not be excessive. More fundamentally, he will demand the basic freedom to decide for himself where to invest and what to produce, where to sell and at what price. He will request the politician, the planner and the administrator to get off his back and to concentrate on their own special tasks of preserving law and order and of building the economic and social infrastructure.

Free enterprise has an unanswerable case as a superior way of life and as a more efficient way of mobilising human and material resources to achieve higher standards for all. The main task of the business man today is to convey this message properly to the Indian public. In so doing he should concern himself less with the negative task of defending his rights as an employer or as a property owner. As a member of a democratic society, he can demonstrate the positive value of his contribution to the economy as an innovator, as a creator of wealth and employment, and as a pioneer in the search for better ways of economising in scarce productive resources and of satisfying the wants of his fellow citizens.

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TWO ESSAYS ON FREE ENTERPRISE

By
F. A. Hayek

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INTRODUCTION

Any society is concerned not only with production of goods and services, and their proper distribution, but also the prevalence and maintenance of moral values. What is the role of the individual and of the state in this effort? What is the concept of individual freedom and of coercion by the state? These are delicate yet all-important questions for a nation like ours, on the threshold of a new era.

This booklet presents an analysis of these problems by one of the leading economists and social thinkers of the world, Mr. F. A. Hayek. His book, "Road to Serfdom", continues to hold the place of a classic analysis of socialism and how it leads to destruction of individual freedoms and democracy. In fact, events have proved him a prophet. One of his latest publications, "The Constitution of Liberty", has likewise been hailed as a landmark in creative thinking on economic and moral problems of the modern society.

The Forum of Free Enterprise is grateful to Prof. Hayek for according it the permission to reproduce two of his articles in the form of a booklet. It is to be earnestly hoped that the words of wisdom contained in these two articles would break the spell of ideology which envelopes many a mind in developing countries like ours.

A. D. SHROFF,

President, Forum of Free Enterprise

An unhindered market provides the most efficient steering of production, because it secures the fullest utilisation of knowledge necesarily dispersed among millions of men. All the resources, material and human, which can be made to serve human needs, exist in countless varieties and forms, distributed widely in space and constantly changing in quantity and quality. What benefits we will derive from them depends on how well the use of the particular items is, at every moment and place, adapted to the ever-changing conditions.

Resources exist for this purpose only to the extent that the concrete facts about them and about the opportunities for their use are known to particular men. The global figures about total stocks or supplies on which a central planner of production has to rely leave out most of the information which should be taken into account in the decision about the use of the individual item. Even with the most standardised raw material, two carloads available at different places or at different times offer different opportunities.

With more complex products such as machines, often no two different items are equally useful for all purposes to which they can be put.

Our productivity depends on the use of the widely dispersed knowledge of these ever-changing concrete facts of place and time. This knowledge can never be at the disposal of a central direction of the economy. It can be used only if the decisions are decentralised and placed in the hands of those who know the particular facts. But if the individuals are to use their knowledge successfully. they must be in a position mutually to adjust their decision so that their individual plans fit into each other, and to take account in these plans of many circumstances of which they do not directly know.

This cannot be achieved by deliberate co-ordination because the co-ordinating agency would have to possess that very knowledge of detail which cannot be concentrated in a single hand.

What is needed, therefore, is an impersonal mechanism of communication which conveys to the individuals just that information which they require in order to adjust their decisions to those of their fellows. This is what prices in an unhindered market will do—not perfectly, but infinitely better than can be achieved by any other known method. They tell each individual not only what others are willing to give for his products or services, but also the relative importance of all the different tools and materials which he can use in supplying other people's needs. They register the relevant effects of countless other facts which the individual, without knowing of those facts themselves, is thus made to take into account.

He need not know why or where one kind of material is more urgently demanded or some service can be more easily dispensed than was the case before. All he need know is that the price of the one has risen and that of the other fallen and he will in consequence be led to economise the former and more freely use the latter.

To appreciate the importance of this, we must remember that almost all human needs can be satisfied in a great variety of ways and that nearly all commodities can be made from a great many different materials and of many different proportions of these materials. How much we shall get from our efforts depends probably less on the total quantity of resources at our disposal than on putting each to the use where it will make the greatest contribution. In order to maximise output, it is necessary to use the different materials and kinds of work in such proportions that the relative contribution of the marginal units is the same in all their different uses.

So long as, *e.g.*, an extra ton of coal will make a greater contribution to the product of one plant than an extra barrel of oil, while at the plant next door the position is the reverse, overall output can clearly be increased if the former substitutes coal for oil and the latter oil for coal. Under competitive conditions this process will go on until the quantities of two such materials which will make the same contribution to the product (taking account of costs of transportation and the like) are the same in all plants.

This result, which is produced by each manufacturer endeavouring to minimise his costs, secures at the same time all round maximum output.

Changes in prices will thus make the individual producer adjust himself to changes which may occur in very different industries or places, of which he does not know directly but whose relevant effects are registered by the prices. Market prices are in this sense the resultant of all the knowledge possessed by the different individuals concerned with a commodity and reflect all the opportunities and needs for its use. They indicate the urgency of different needs, the expediency of substitutions, and all the opportunities people believe to exist for the use of the commodities, now or in the future.

This, however, is true only of prices as they will be determined in an unhindered market, that is, a market at which prices make demand equal supply. Only if anyone who wishes is allowed to supply or buy any commodity or service, at any price and at any quantity he chooses, will prices fulfil this function. Prices which are not determined under such conditions, and at which those willing to sell or buy are not able to sell or buy as much as they wish, lead to misdirections of production and waste. With such prices some resources will not be turned to the most productive use and others that should be used will remain altogether idle.

As the term Government intervention is now often used in a vague sense which suggests that all Government concern with economic matters is objectionable, it must be stressed that only Government interference with prices, quantities, and the entry into trades is altogether incompatible with a free market. There is much Government may do or indeed must do in order to keep the market functioning—above all it must enforce the ordinary rules of law. But if the individuals are to use their own knowledge in the allocation of resources effectively, the actions of Government must be predictable. So far as Government acts according to known rules of law it assists the individuals in their own efforts by providing fixed data on which they can base their plans.

Yet prices, quantities, or the entry into trades, cannot be determined by rules. Any attempt to regulate them by decree must take account of every changing circumstance and be guided by the particular preferences and aims of the authority. Such measures are, therefore, in their very nature, unpredictable, discretionary and essentially arbitrary.

In other words, it is the character rather than the volume of Government activity that is important. A functioning market economy presupposes certain activities on the part of the state; there are some other such activities by which its functioning will be assisted; and it can tolerate many more, provided that they are of the kind which are compatible with a functioning market. But there are those which run counter to the very principle on which a free system rests and which must, therefore, be altogether excluded if such a system is to work.

In consequence, a Government that is comparatively inactive but does the wrong thing may do much more to cripple the forces of a market economy than one that is more concerned with economic affairs but confines itself to actions which assist the spontaneous forces of the economy.

The criterion which enables us to distinguish between those measures which are and those which are not compatible with a free system is thus conformity with the principles of the rule of law. All measures that satisfy its requirements may be examined further on grounds of expediency. Many of them will, of course, still be undesirable or even harmful. But those that are not must be rejected even if they provide an effective, or perhaps the only effective, means to a desirable end. It is true that the observation of the rule of law is only a necessary, but not yet a sufficient condition for the working of a free economy. The important point, however, remains, that all coercive action of Government must be unambiguously determined by a permanent legal framework which enables the individual to plan with a degree of confidence and which reduces human uncertainty as much as possible.

The main function of this permanent legal frame-work is to reduce coercion of individuals by other individuals as much as possible. It must be realised that at the present time Government does not even adequately perform this essential and indispensable function. It has granted trade unions unique privileges of coercion towards workers unwilling to join them, which are entirely contrary to the principles on which a free system rests. Here a much more consistent application of the basic principles of the rule of law would be desirable if the market is to work efficiently.

The function of law in a free society is predominantly to prevent violence and coercion. fraud and deception. To enforce the rules which will achieve this, and for this purpose only, Government must possess the power to coerce and ought to have the monopoly of coercion. But we shall not overlook that the coercive functions of Government are not its only functions and that there are many pure service functions which it may undertake where coercion does not enter or does so only through the need of financing them through taxation. In so far as the Government merely undertakes to supply services which otherwise would not be supplied at all (usually because it is not possible to confine the benefits to those prepared to pay for them), the only question which arises is whether the benefits are worth the cost. Of course, if the Government claims for itself the exclusive right to provide particular services, they would cease to be strictly non-coercive. In general, a free society demands not only that the Government have the monopoly of coercion, but that it have the monopoly *only* of coercion and that in all other respects it operate on the same terms as everybody else.

A great many of the activities which Governments have universally undertaken in this field which fall within the limits described are those which facilitate the acquisition of reliable knowledge about facts of general significance. The most important function of this kind is the provision of a reliable and efficient monetary system. Others scarcely less important are the setting of standards of weights and measures; the providing of information gathered from surveying, land registration, statistics, etc; and the support, if not also the organisation, of some kind of education.

All these activities of Government are part of its effort to provide a favourable framework for individual decisions; they supply the means which individuals can use for their own purposes. Many other services of a more material kind fall into the same category. Though in a free society Government ought not reserve to itself activities which have nothing to do with the enforcement of the general rules of law and the assurance of a protected private sphere to the individual, there is no violation of the basic principles of such a society if the Government engages in all sort of activities on the same terms as the citizens. If in the majority of fields there is no good reason why it should do so, there are fields in which the desirability of Government action can hardly be questioned.

To this latter group belong all those services which are clearly desirable but will not be provided by competitive enterprise because it would either be impossible or difficult to charge the individual beneficiary for them. Such are most sanitary and health services, often the construction and maintenance of roads, and many of the amenities provided by municipalities for inhabitants of cities. There are also many other kinds of activity in which Government may legitimately wish to engage, in order perhaps to maintain secrecy in military preparations or to encourage the advance of knowledge in certain fields. But though Government may at any moment be best qualified to take the lead in such fields, this provides no justification for assuming that this will always be so and, therefore, for giving it exclusive responsibility. In most instances, moreover, it is by no means necessary that the Government engage in the actual management of such activities; the services in question can generally be provided, and more effectively provided, by the Government's assuming some of all the affairs to independent and in some measure competitive agencies.

There is considerable justification for the distrust with which business looks on *all* state enterprise. There is great difficulty in ensuring that such enterprise will be conducted on the same terms as private enterprise; and it is only if this condition is satisfied that it is not objectionable in principle. So long as a Government uses any of its coercive powers, and particularly its power of taxation, in order to assist its enterprises, it can always turn its position into one of actual monopoly. To prevent this, it would be necessary that any special advantages, including subsidies, which Government gives to its own enterprises in any field, also be made available to competing private agencies. There is no need to emphasise that it would be exceedingly difficult for Government to satisfy these conditions and that the general presumption against state enterprise is thereby considerably strengthened. But this does not mean that all state enterprise must be excluded from a free system. Certainly it ought to be kept within narrow limits; it may become a real danger to liberty if too large a section of economic activity comes to be subject to the direct control of state. But what is objectionable here is not state enterprise as such but state monopoly.

Furthermore, a free system does not exclude on principle all those general regulations of economic activity which can be laid down in the form of general rules specifying conditions which everybody who engages in a certain activity must satisfy.

These include, in particular, all-regulations governing the technique of production. We are not concerned here with the question of whether such regulations will be wise, which they probably will be only in exceptional cases. They will always limit the scope of experimentation and thereby obstruct what may be useful developments. They will normally raise the cost of production or, what amounts to the same thing, reduce over-all productivity. But if this effect on cost is fully taken into account and it is still thought worthwhile to incur the cost to achieve a given end, there is little more to be said about it. The economist will remain suspicious and hold that there is a strong presumption against such measures because their over-all costs are almost always underestimated and because one disadvantage in particular — namely the prevention of new developments — can never be taken fully into account.

But if, for instance, the production and sale of phosphorous matches are generally prohibited for reasons of health, or permitted only if certain precautions are taken, or if night work were generally prohibited, the appropriateness of such measures might be judged by comparing the over-all cost with the gain; it cannot be conclusively determined by appeal to a general principle. This is true of most of the wide field of regulation known as factory regulation.

The range and variety of Government action that is, at least in principle, reconcilable with a free system is thus considerable. The old formulae of *laissez faire* or non-intervention do not provide us with an adequate criterion for distinguishing between what is and what is not admissible in a free system. There is ample scope for experimentation and improvement within that permanent legal framework which makes it possible for a free society to operate most efficiently.

Why, then, has there been such persistent pressure to do away with those limitations upon Government that were erected for the protection of individual liberty? And if there is so much scope for improvement within the rule of law, why have the reformers striven so constantly to weaken and undermine it? The answer is that during the last few generations certain new aims of policy have emerged which cannot be achieved within the limits of the rule of law. A Government which cannot use coercion except in the enforcement of general rules has no power to achieve particular aims that require means other than those expicitly entrusted to its care and, in particular, cannot determine the material position of particular people or enforce distributive or "social" justice. In order to achieve such aims, it would have to pursue a policy which is best described—since the word "planning" is so ambiguous—by the French word *dirigisme,* that is, a policy which determines for what specific purpose particular means are to be used.

This, however, is precisely what a Government bound by the rule of law cannot do. If the Government is to determine how particular people ought to be situated, it must be in a position to determine also the direction of individual efforts. If Government treats different people equally, the results will be unequal and if it allows people to make what use they like of the capacities and means at their disposal, the consequences for the individuals will be unpredictable.

The restrictions which the rule of law imposes upon Government thus preclude all those measures which would be necessary to ensure that individuals will be rewarded according to another's conception of merit or desert rather than according to the value that their services have to their fellows—or, what amounts to the same thing—it precludes the pursuit of distributive as opposed to commutative justice. Distributive justice requires an allocation of all resources by a central authority; it requires that people be told what to do and what ends to serve. Where distributive justice is the goal, the decision as to what the different individuals must be made to do cannot be derived from general rules but must be made in the light of the particular aims and knowledge of the planning authority. Where the opinion of the community decides what different people shall receive, the same authority must also decide what they shall do.

THE MORAL ELEMENT IN FREE ENTERPRISE

Economic activity provides the material means for all our ends. At the same time, most of our individual efforts are directed to providing means for the ends of others in order that they, in turn, may provide us with the means for our ends. It is only because we are free in the choice of our means that we are also free in the choice of our ends.

Economic freedom is thus an indispensable condition of all other freedom, and free enterprise both a necessary condition and a consequence of personal freedom. In discussing The Moral Element in Free Enterprise I shall therefore not confine myself to the problems of economic life but consider the general relations between freedom and morals.

By freedom in this connection I mean, in the great Anglo-Saxon tradition, independence of the arbitrary will of another. This is the classical conception of freedom under the law, a state of affairs in which a man may be coerced only where coercion is required by the general rules of law, equally applicable to all, and never by the discretionary decision of administrative authority.

The relationship between this freedom and moral values is mutual and complex. I shall, therefore, have to confine myself to bringing out the salient points in something like telegraphic style.

It is, on the one hand, an old discovery that morals and moral values will grow only in an environment of freedom, and that in general moral standards of people and classes are high only where they have long enjoyed freedom—and proportional to the amount of freedom they have possessed. It is also an old insight that a free society will work well only where free action is guided by strong moral beliefs, and, therefore, that we shall enjoy all the benefits of freedom only where freedom is already well established. To this I want to add that freedom, if it is to work well, requires not only strong moral standards but moral standards of a particular kind, and that it is possible in a free society for moral standards to grow up which, if they become general, will destroy freedom and with it the basis of all moral values.

Before I turn to this point, which is not generally understood, I must briefly elaborate upon the two old truths which ought to be familiar but which are often forgotten. That freedom is the matrix required for the growth of moral values—indeed not merely one value among many but the source of all values—is almost self-evident. It is only where the individual has choice, and its inherent responsibility, that he has occasion to affirm existing values to contribute to their further growth, and to earn moral merit. Obedience has moral value only where it is a matter of choice and not coercion. It is in the order in which we rank our different ends that our moral sense manifests itself; and in applying the general rules of morals to particular situations each individual is constantly called upon to interpret and apply the general principles and in doing so create particular values.

This has in fact brought it about that free societies not only have generally been law-abiding societies, but also in modern times have been the source of all the great humanitarian movements aiming at active help to the weak, the ill, and the oppressed. Unfree societies, on the other hand, have as regularly developed a disrespect for the law, a callous attitude to suffering, and even sympathy for the malefactor.

I must turn to the other side of the medal. It should also be obvious that the results of freedom must depend on the values which free individuals pursue. It would be impossible to assert that a free society will always and necessarily develop values of which we would approve, or even, as we shall see, that it will maintain values which are compatible with the preservation of freedom. All that we can say is that the values we hold are the product of freedom, that in particular the Christian values had to assert themselves through men who successfully resisted coercion by government, and that it is to the desire to be able to follow one's own moral convictions that we owe the modern safeguards of individual freedom. Perhaps we can add to this that only societies which hold moral values essentially similar to our own have survived as free societies, while in others freedom has perished.

All this provides strong argument why it is most important that a free society be based on strong moral convictions and why if we want to preserve freedom *and* morals, we should do all in our power to spread the appropriate moral convictions. But what I am mainly concerned with is the error that men must first be good before they can be granted freedom.

It is true that a free society lacking a moral foundation would be a very unpleasant society in which to live. But it would even so be better than a society which is unfree and immoral; and it at least offers the hope of a gradual emergence of moral convictions which an unfree society prevents. On this point, I strongly disagree with John Stuart Mill, who maintained that until men have attained the capacity of being guided to their own improvement by conviction or persuasion, "there is nothing for them but implicit obedience to an Akbar or Charlemagne, if they are so fortunate as to find one." Here I believe T. B. Macaulay expressed the much greater wisdom of an older tradition, when he wrote that "many politicians of our time are in the habit of laying it down as a self-evident proposition that no people are to be free till they are fit to use their freedom. The maxim is worthy of the fool in the old story, who resolved not to go into the water till he had learned to swim. If men are to wait for liberty till they become wise and good, they may indeed wait forever."

I have said that liberty, to work well, requires not merely the existence of strong moral convictions but also the acceptance of particular moral views. By this I do *not* mean that within limits utilitarian considerations will contribute to alter moral views on particular issues. Nor do I mean that, as Edwin Cannan expressed it, "of the two principles, Equity and Economy, Equity is ultimately the weaker....the judgment of mankind about what is equitable is liable to change, and.....one of the forces that causes it to change is mankind's discovery from time to time that what was supposed to be quite just and equitable in some particular matter has become, or perhaps always was, uneconomical."

This is also true and important, though it may not be a commendation to all people. I am concerned rather with some more general conceptions which seem to me an essential condition of a free society and without which it cannot survive. The two crucial ones seem to me the belief in individual responsibility and the approval as just of an arrangement by which material rewards are made to correspond to the value which a person's particular services have to his fellows; *not* to the esteem in which he is held as a whole person for his moral merit.

I must be brief on the first point—which I find very difficult. Modern developments here are part of the story of the destruction of moral value by scientific error which has recently been my chief concern—and what a scholar happens to be working on at the moment tends to appear to him as the most important subject in the world.

Free societies have always been societies in which the belief in individual responsibility has been strong. They have allowed individuals in act on *their* knowledge and belief and have treated the results achieved as due to them. The aim was to make it worthwhile for people to act rationally and reasonably and to persuade them that what they would achieve depended chiefly on them. This last belief is undoubtedly not entirely correct, but it certainly had a wonderful effect in developing both initiative and circumspection.

By a curious confusion it has come to be thought that this belief in individual responsibility has been refuted by growing insight into the manner in which events generally, and human actions in particular, are determined by certain classes of causes. It is probably true that we have gained increasing understanding of the *kinds* of circumstances which affect human action—but no more. We can certainly not say that a result of particular circumstances that we can specify—leaving out his peculiar individuality built up by the whole of his history. Of our generic knowledge as to how human action can be influenced we make use in assessing praise and blame—which we do for the purpose of making people behave in a desirable fashion. It is on this limited determinism—as much as our knowledge in fact justifies—that the belief in responsibility is based, while only a belief in some metaphysical self which stands outside the chain of cause and effect could justify the contention that it is useless to hold the individual responsible for his actions.

Yet, crude as is the fallacy underlying the opposite and supposedly scientific view, it has had the most profound effect in destroying the chief device which society has developed to assure decent conduct—the pressure of opinion making people observe the rules of the game. And it has ended in that *Myth of Mental Illness* which a distinguished psychiatrist, Dr. T. S. Szasz, has recently justly castigated in a book so titled. We have probably not yet discovered the best way of teaching people to live according to rules which make life in society for them and their fellows not too unpleasant. But in our present state of knowledge I am sure that we shall never build up a successful free society without that pressure of praise and blame which treats the individual as responsible for his conduct and also makes him bear the consequences of even innocent error.

But if it is essential for a free society that the esteem in which a person is held by his fellows depends on how far he lives up to the demand for moral law, it is also essential that material reward should *not* be determined by the opinion of his fellows of his moral merits but by the value which they attach to the particular services he renders them. This brings me to my second chief point: the conception of social justice which must prevail if a free society is to be preserved. This is the point on which the defenders of a free society and the advocates of a collectivist system are chiefly divided. And on this point, while the advocates of the socialist conception of distributive justice are usually very outspoken, the upholders of freedom are unnecessarily shy about stating bluntly the implications of their ideal.

The simple facts are these: We want the individual to have liberty because only if *he* can decide what to do can he also use all his unique combination of information, skills and capacities which nobody else can fully appreciate. To enable the individual to fulfill his potential we must also allow him to act on his own estimates of the various chances and probabilities. Since we do not know what he knows, we cannot decide whether his decisions were justified; nor can we know whether his success or failure was due to his efforts and foresight, or to good luck. In other words, we must look at results, not intentions or motives, and can allow him to act on his own knowledge only if we also allow his to keep what his fellows are willing to pay him for his services, irrespective of whether we think this reward appropriate to the moral merit he has earned or the esteem in which we hold him as a person.

Such remuneration, in accordance with the value of a man's services, inevitably is often very different from what we think of his moral merit. This, I believe, is the chief source of the dissatisfaction with a free enterprise system and of the clamour for "distributive justice". It is neither honest nor effective to deny that there is such a discrepancy between the moral merit and esteem which a person may earn by his actions and, on the other hand, the value of the services for which we pay him. We place ourselves in an entirely false position if we try to gloss over this fact or to disguise it. Nor have we any need to do so.

It seems to me one of the great merits of a free society that material regard is *not* dependent on whether the majority of our fellows like or esteem us personally. This means that, so long as we keep within the accepted rules, moral pressure can be brought on us only through the esteem of those whom we ourselves respect and not through the allocatin of material reward by a social authority. It is of the essence of a free society that we should be materially rewarded not for doing what others order us to do, but for giving them what they want. Our conduct ought certainly to be guided by our desire for their esteem. But we are free because the success of our daily efforts does not depend on whether particular people like us, or our principles, or our religion, or our manners, and because *we* can decide whether the material reward others are prepared to pay for our services makes it worth while for us to render them.

We seldom know whether a brilliant idea which a man suddenly conceives, and which may greatly benefit his fellows, is the result of years of effort and preparatory investment. or whether it is a sudden inspiration induced by an accidental combination of knowledge and circumstance. But we do know that, where in a given instance it has been the former, it would not have been worth while to take the risk if the discoverer were not allowed to reap the benefit. And since we do not know how to distinguish one case from the other, we must also allow a man to get the gain when his good fortune is a matter of luck.

I do not wish to deny, I rather wish to emphasise, that in our society personal esteem and material success are much too closely bound together. We ought to be much more aware that if we regard a man as entiled to a high material reward that in itself does not necessarily entitle him to high esteem. And, though we are often confused on this point, it does not mean that this confusion is a necessary result of the free enterprise system—or that in general the free enterprise system is more materialistic than other social orders. Indeed, and this brings me to the last point I want to make, it seems to me in many respects considerably less so.

In fact, free enterprise has developed the only kind of society which, while it provides us with ample material means, if that is what we mainly want, still leaves the individual free to choose between material and nonmaterial reward. The confusion of which I have been speaking —between the value which a man's services have to his fellows and the esteem he deserves for his moral merit —*may* well make a free enterprise society materialistic. But the way to prevent this is certainly not to place the control of all material means under a single direction, to make the distribution of material goods the chief concern of all common effort and thus to get politics and economics inextricably mixed.

It is at least possible for a free enterprise society to be in this respect a pluralistic society which knows no single order of rank but has many different principles on which esteem is based; where worldly success is neither the only evidence nor regarded a certain proof of individual merit. It may well be true that periods of a very rapid increase of wealth, in which many enjoy the benefits of wealth for the first time, tend to produce for a time a predominant concern with material improvement. Until the recent European upsurge many members of the more comfortable classes there used to decry as materialistic the economically more active periods to which they owed the material comfort which had made it easy for them to devote themselves to other things.

Periods of great cultural and artistic creativity have generally followed, rather than coincided with, the period of the most rapid increase in wealth. To my mind this shows *not* that a free society must be dominated by material concerns but rather that with freedom it is the moral atmosphere in the widest sense, the values which people hold, which will determine the chief direction of their activities. Individuals as well as communities, when they feel that other things have become more important than material advance, can turn to them. It is certainly not by the endeavour to make material reward correspond to all merit, but only by frankly recognising that there are other and often more important goals than material success, that we can guard ourselves against becoming too materialistic.

Surely it is unjust to blame a system as more materialistic because it leaves it to the individual to decide whether he prefers material gain to other kinds of excellence, instead of having this decided for him. There is indeed little merit in being idealistic if the provision of the material means required for these idealistic aims is left to somebody else. It is only where a person can himself choose to make a material sacrifice for a non-material end that he deserves credit. The desire to be relieved of the choice, and of any need for personal sacrifice, certainly does not seem to me particularly idealistic.

I must say that I find the atmosphere of the advanced Welfare State in every sense more materialistic than that of a free enterprise society. If the latter gives individuals much more scope to serve their fellows by the pursuit of purely materialistic aims, it also gives them the opportunity to pursue any other aim they regard as more important. One must remember, however, that the pure idealism of an aim is questionable whenever the material means necessary for its fulfillment have been created by others.

In conclusion, I want to return to the point from which I started. When we defend the free enterprise system we must always remember that it deals only with means. What we make of our freedom is up to us. We must not confuse efficiency in providing means with the purposes which they serve. A society which has no other standard than efficiency will indeed waste that efficiency. If men are to be free to use their talents to provide us with the means we want, we must remunerate them in accordance with the value these means have to us. Nevertheless, we ought to esteem them only in accordance with the use they make of the means at *their* disposal.

Let us encourage usefulness to one's fellows by all means, but let us not confuse it with the importance of the ends which men ultimately serve. It is the glory of the free enterprise system that it makes it at least possible that each individual, while serving his fellows, can do so for his own ends. But the system is itself only a means and its infinite possibilities must be used in the service of ends which exist apart.

4

FREEDOM AND ECONOMIC GROWTH

IS SOCIALISM THE ANSWER?

By

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Millions go hungry in Asia, Africa and Latin America not because the world cannot produce enough rice and grain, but because the leaders of mankind are blinded by ideologies and a strange confusion of values. Neither capital nor natural resources assure economic growth.

Switzerland is poor in natural resources and its climate is harsh, yet the Swiss enjoy one of the highest standards of living in the world, thanks to a happy combination of hard work, private initiative, a high regard for private property rights, and a well developed sense of social responsibility. Brazil, on the other hand, which in terms of natural wealth is potentially one of the richest countries in the world, is heavily dependent upon foreign aid, and more than 50% of the Brazilian people suffer from malnutrition.

The German "miracle,"—the rise within 15 years from utter devastation to a high degree of prosperity—was not the result of foreign aid, which actually amounted to less than the billions carried away in the form of reparations, nor of natural resources, but of sound economic policies and a strong belief in private initiative and personal freedom, a conviction which was slowly and painfully acquired during fifteen years of economic regimentation.

What makes Malaya prosperous and keeps the Indonesian masses near the starvation level? Both countries are rich in tin, rubber and oil, but Malaya's currency is stable and the country attracts foreign investments, while the Indonesian Rupiah sells in the free market at about 25% of its official value. Malaya believes in economic freedom and respects private property rights, while Indonesia hampers private initiative, nationalises or confiscates private property, and in the end fails to carry through its grandiose economic blueprints.

One hundred and fifty years ago, India was richer and economically more developed than Japan. The opposite is true today. During the past decade alone, Japan's national income increased three times as fast as that of India. Can this difference really be explained only by the fact that India lived for almost 200 years under British colonial rule, while Japan was able to retain her independence?

Five hundred years ago, the great nations of Asia were more powerful and far richer than the nations of Europe. Yet 200 years later the Europeans were well on their way to make themselves the masters of five continents. The world was not conquered by superior resources and greater fighting power, but a new spirit of private initiative, of respect for hard work and for material values, which Europe had not known during the Middle Ages, and which much of the world lacks today.

How can the people of Asia, Africa and Latin America capture the secret which has made possible the economic and social advance of Europe and North America during the past 150 years? They cannot import socio-economic systems like potted plants and expect them to grow. All they can hope for is to gather the seeds of carefully selected ideas, plant them in their own soil and slowly raise a new plant, a combination of proven foreign ideas and indigenous strength. Foreign influences can be stimulating, but they can also have a sterilizing effect. An imported machine civilization can easily destroy traditional cultural values, and in the end produce social chaos and economic stagnation rather than material progress. Japan did not copy Europe. It assimilated certain ideas and forms and shaped them to its own needs. Free enterprise, capitalism and economic progress are not based on "cocacolanization."

Far more dangerous for an underdeveloped country, than an attempt to copy too literally economic institutions which proved effective in the socio-economic development of other countries, is the tendency among many foreign economic advisers of today and the leaders of many underdeveloped countries to promote ideas, which, although politically expedient from the point of view of the ruling politicians, have proven conspicuous failures in the more developed countries, and which are manifestly inapplicable to underdeveloped countries. This holds equally true of the totalitarian brand of economic planning, which has turned one-third of the world into an ill-fed prison, as well as of the Keynesian and welfare state types of socialism which have retarded the economic recovery of post-war Britain, and, in more recent years, have been chiefly responsible for the relative decline in economic strength of United States.

Totalitarianism and welfare state socialism promise economic growth and "freedom from want." Yet neither can achieve both, and in the end both may prove unable to provide either, because both philosophies spring from a basic misunderstanding of human nature. Man is more than an economic being which can be satisfied in the long run with bread and circuses. The communists boast of the rapid industrialisation of Russia, but fail to mention the continued poverty of the masses and the suppression of basic freedoms. The welfare state advocates speak of "freedom from want" as a basis for democracy and a shield against communism, and seemingly fail to see that their slogan involves a semantic confusion, because they do not really believe in "freedom," but rather in a policy under which the individual surrenders his freedom in return for economic security provided by a more or less powerful state. This is obviously not a new idea, even though it is presented as such to the historically illiterate masses of the 20th century. The same desire for economic security which we witness today prevailed during the troubled years of disintegration of the Roman empire, and developed gradually into the system of feudalism and serfdom of the Middle Ages. The slaves and serfs of yester-years, if theirs was a good master, enjoyed a considerable degree of economic security. But good masters have a tendency of turning into tyrants, and who assures the modern would-be serf that his new master, the all-powerful state, will remain benevolent. The millions of kulaks killed in the course of Stalin's economic reforms, and the twenty million Chinese who perished as part of the cost China paid for its industrialisation are silent and gruesome monuments to the new philosophy of "freedom from want." No one enjoys greater economic security than the inmate of an American jail, who has been sentenced to life imprison-ment. All his material needs are looked after by state. But how many people in the underdeveloped countries would trade their personal freedom, however desperate their economic misery, for the relatively high standard of living of an American prison?

To expect the totalitarian state to increase materially the average standard of living is contrary to all logic, even if Russia did not provide ample evidence against this naive faith in totalitarian benevolence. Like any organism, the Leviathan state must continuously add to its own power: guns instead of butter; moon-rockets instead of adequate housing. Because of its very nature, the total state cannot permit the individual to grow in either personal freedom or economic strength.

All this is different, we are told, in the case of the socialistic welfare state, as if Fabian socialism had not been disproven by the post-war socialist experiments of the British Labour Party, from which the British economy has not fully recovered to this day. Intellectuals throughout the world like to challenge the ethics of free enterprise, which are supposedly based on greed and an asocial selfishness, and to uphold the ethics of socialism. But quite aside from the utter failure of socialism to provide the economic progress it promises, its ethical arguments are based on an illusion. Socialism has all the weaknesses and none of the strength of either totalitarianism or free enterprise. While it lacks the brutality of the totalitarian state, it also lacks its strength which makes possible forced economic growth at the expense of individual freedom and wellbeing. On the other hand, socialism paralyzes the dynamic powers of free enterprise, which during the 19th century provided Europe with a rapidly rising standard of living, a tremendous increase in economic power, and an unprecedented expansion of personal liberties. The modern socialists no less than the advocates of communism are the 20th century followers of Hobbes, the great defender of 17th century absolutism, who argued, just as the modern planners argue today, that man is inherently asocial and unable to use his purchasing power rationally, so that we need a strong state to curb the individual and regulate production and consumption.

Nor will the socialists, statist-interventionists and economic planners learn from the failures of their past experiments. They are like the man who believed that he could fly, but broke a leg when he jumped from a second storey window. "I just didn't have enough altitude," he argued, and when his leg had healed, he jumped from the sixth floor and was killed. When a billion dollars spent on some economic experiment proves an utter waste of money, the economic planners assure the voters that they would succeed, if they could only spend ten billion dollars.

By far the largest recipient of American aid is not India, Korea, or any other underdeveloped country, but the highly mechanised and scientifically operated American farm industry. In the 1961-62 fiscal year alone farm subsidies will amount to $5 bill., compared with the total net income of American farmers, including the subsidies of $12.7 bill. in 1961. But government aid, planning and steadily increasing regimentation has not cured the ills of American agriculture. Here is what the President of the American Farm Bureau Federation, one of the two large farm organisations in America, has to say: "America has been known as the land of opportunity, but opportunity depends upon freedom and freedom means individual responsibiliy—not the rule of force by government. The government interventionist abandons freedom of choice because he is contemptuous of the ability of individuals to know what is best for them. The result is that those who favour government intervention soon recognise the market price system as their principal target and set out to replace it with price fixing and controls."

Mahatma Gandhi realised the dangers of the all-powerful state, when he wrote: "While apparently doing good by minimising exploitation, the state does the greatest harm to mankind by destroying individuality which is the root of all progress. The state represents violence in a concentrated and organised form.. The state is a soulless machine; it can never be weaned from violence to which it owes its very existence." Nor did Gandhi believe in the planned socialist state: "Controls give rise to fraud, suppression of truth, intensification of the black market and to artificial scarcity. Above all, it unmans the people and deprives them of initiative; it undoes the teaching of self-help they have been learning for a generation. It makes them spoonfed." How different Prime Minister Nehru: "Without social freedom and a socialistic structure of society and the state, neither the country nor the individual could develop.... A real government by the people and for the people can only be established when the masses hold power, that is under socialism when all the people really share in the government and wealth of the country."

Mr. Nehru's philosophy—and this philosophy is shared by many American economists and politicians—rests on two false premises: that a totalitarian or socialist state is actually a "people's republic" in which the people have a choice; and that the people, rather than the ruling bureaucracy,—or the state as a moloch—enjoy the wealth of the country.

Collectivism is nothing new. It was overthrown in Europe and North America in three bitter struggles: the Glorious Revolution of 1688 in England, the American Revolution of 1776, and the French Revolution of 1789. In each case, the power passed from the ruling aristocracy and its proliferating bureaucracy to the entrepreneurial middle class, and it was this step which precipitated the rapid economic growth of Europe and North America. Modern totalitarianism and socialism have all the earmarks of the European absolutism and mercantilism of 300 to 400 years ago: the replacement of social conscience by jingoistic nationalism, the glorification of the state, the contempt for the individual, the disregard for agriculture, the emphasis upon fiscal and monetary manipulations, a naive economic pragmatism which neglects economic forces.

The very same ideas which Europe and North America had to defeat before their economies could develop, are presented today to the underdeveloped countries, including India, as the recipe by which to achieve economic growth.

THE REAL PATH OF ECONOMIC DEVELOPMENT

Few nations have been successful in developing an industrial system until they were able to produce agricultural surpluses. The industrial revolution of England followed and coincided with a rapid development of agriculture. The farm surpluses necessary to feed the growing industrial population require a gradual change from a primitive local self-sufficiency to the production of marketable surpluses. Land reforms, which are at present widely advertised as the solution of Latin America's problems, may or may not meet the needs of increased production. When the large estates of eastern Germany, which due to scientific farming and centuries of careful tending produced before the war large surpluses, were distributed among the workers and deserving party members, the production dropped sharply, and before long the communist regime found it necessary to unite the individual farms into cooperatives with the peasant, like the serf of yester-years, prohibited from leaving the land. In theory, new collectives could have been operated as efficiently as were the former private estates, but in reality they are not, and eastern Germany, which was a food exporter before the war, is now dependent upon food imports despite a sharp decline in the total population and in the *per capita* consumption.

The tendency in underdeveloped countries to overlook the importance of agriculture as a basis, if not a prerequisite for industrial and economic growth in general, is in part at least the result of a prejudice dating from the colonial rule. The new nations no longer wish to be merely the producers of raw materials, the handmaidens of industrial nations. Dr. Raul Prebisch, one of Latin America's best known economists, has built a whole theory of economic development upon this assumption, forgetting completely that until the end of the last century, the major portion of United States exports consisted of two farm products: cotton and wheat, and that even today farm exports account for about one-fourth of United States exports. The expansion of farm production even during decades of declining prices, did not prevent, but actually made possible the industrialisation of the United States.

Since the United States is today the most highly industrialised and mechanised nation and enjoys the highest standard of living, the leaders of many underdeveloped nations jump to the conclusion that their economic problems can be solved if they can only build enough modern factories. This is a dangerous illusion. The steel production does not necessarily determine "the tempo of progress of the economy as a whole", as India's Second Five-Year Plan assumed. The demand for steel is not self-generating, neither is the demand for machinery. Industrialisation requires a peculiar type of skilled worker, quite different from the skilled artisan, and a market for finished industrial products. Neither can be developed overnight, and stronger the cultural ties of a peasant-handicraft culture, the greater the difficulty of producing modern industrial workers and demand for machine-made products. Europe required centuries to achieve the transition. To speed this cultural process through government fiat, as the totalitarian countries have attemped, causes a profound cultural shock and indirectly retards economic development.

The case against heavy industries, created by the government and financed through heavy taxation or inflation, is particularly obvious in India with its very large supply of cheap labour, and its acute shortage of investment capital. Economic logic calls, for the time being at least, for labour rather than capital-intensive industries. It requires at least $ 10,000 in capital investments to provide one job in an automated steel plant, compared with $ 100 to $ 200 in cottage industries. S me 100,000 steel plows at $20 each will do far more for India's economic development than a $ 2 million machine tool.

This raises the whole problematic question of capital formation and investments. One may well question a recent statement by one of India's highest government officials that "there is only one factor of growth missing, and that is capital." Even though capital is admittedly important, the lack of certain pschological, cultural and social prerequisites is probably a far more critical and difficult handicap. There are four ways in which investments can be financed: through private savings, private foreign investments, government funds obtained through taxation or through the printing press; and finally through foreign aid or inter-government loans. It is a widely held misconception that the four are complementary. The inter-American "Alliance of Progress" is based on this illusion. The four sources of investment capital can be complementary under ideal conditions, but in reality they are often mutually destructive. Private domestic capital formation and private foreign investments go hand-in-hand. Traditionally one depends upon the other. Public investments, on the other hand, whether financed through taxation or through inflation, are likely to hamper—contrary to post-Keynesian doctrine — both private capital formation and private foreign investments, unless great care is taken not to undermine private capital formation through heavy taxation and to discourage private investments through direct government competition. Unfortunately, modern economic planners are rarely satisfied to use public funds to prepare the basis on which a private economy can develop. Instead of building roads, schools, irrigation systems, and enforce social and economic order, modern economic planners build steel mills and power plants in direct competition with private enterprise, and yet they wonder why private enterprise seeks greener pastures in other countries.

Foreign aid can provide a sound basis for economic development, but the temptation of inter-governmental loans being used to expand the public sector at the expense of the private sector is obvious. The leaders of many underdeveloped countries and certainly many American experts, trained in Keynesian theories and raised in the spirit of the "New Deal," are basically distrustful of private enterprise and too impatient to permit the development of a free economy by logical stages. They build steel mills before the peasant has learned to use a steel plow, they build super-highways instead of all-weather feeder roads even though the price of the cheapest car is equal to the average *per capita* income for ten years. When Mexico and more recently Colombia, nationalised the remaining private power plans in which American investors held a substantial stake, the foreign exchange needed to pay off the American owners was obtained through a loan from Washington. Instead of being used to build more power plants, American aid was used to spread socialism. Why should private investors, under such circumstances, risk their capital?

Investment policies in underdeveloped countries suffer from a basic defect in economic reasoning. Instead of starting with the available resources and planning their most effective allocation, much of what passes as economic planning in underdeveloped countries is concerned with production goals, usually far beyond the available supply of capital and skilled workers. While there is an old saying that some men succeed better than others because they attempt more, and the fraudulent check-passer may succeed better for a while than his more honest neighbour, in the long run he is likely to get into trouble; and inflating the currency in order to achieve utopian production goals, like passing bad checks, is a form of fraud, as the two great scholastic writers, Buridan and Oresme already warned more than 500 years ago. Nor does inflation pay in the long run. It hampers private capital formation, drives existing private capital abroad or into sterile treasure hoards, and scares away foreign investors.

Of all the dangerous socio-economic theories which have found wide currency in recent years, probably the most deadly is the idea, which always appeals to spend-happy politicians, that a nation need not worry about the effect of rising prices on the balance of payments as long as the national income continues to grow at a rapid rate. As THE ECONOMIST wrote recently: "One cannot believe the governments of the United States and Britain will labour under artificial and irrational restraints on their economic growth,"—meaning, the maintenance of a sound balance of payments position. In order to import machinery essential to economic growth, underdeveloped countries must export and they will find their foreign markets vanishing, if their prices rise above world market prices. The "growth-through-inflation" formula is undermining the strength of the United States, and it makes impossible the economic development of India except on a totalitarian basis and at a cost in human dignity and well-being far greater than even Mahatma Gandhi could have anticipated when he called the state a "soulless machine" which "can never be weaned from violence."

5

CONDITIONS FOR ECONOMIC GROWTH

By
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How can India progress most rapidly from relatively very low average standards of living to standards comparable with those achieved in, say, Western Europe and United States?

The question can be usefully put in another form. Why is it that, in spite of an ancient cultural background and in spite of powerful world forces which (it will be argued) are tending to spread to underdeveloped areas the modern technologies of industry and agriculture, with the accompanying outputs, high wages and good living conditions, the great mass of the Indian people are somehow being prevented from enjoying what the world has been offering her?

This reference to what the world has been "offering" does *not* relate to that assistance which, springing from altruism and enlightened self-interest, takes the form of "foreign aid" to friendly nations. Gifts of that kind, we shall argue, are of negligible importance in relation to what foreign profit-seekers for whom no altruistic intention can be claimed, would be able to achieve for the poverty-stricken Indian masses if policies in India were *rationally* aiming at the rapid material advancement of the common people.

The speed of growth in material well-being on the part of any under-developed region depends ultimately upon the thrift of its people. For thrift is simply the net accumulation of capital.

By "capital"[1], we usually mean income-earning assets; but as used here the term is intended to include also what we today call "human capital". Capital in this form is accumulated through the improvement of the powers of the people, especially by means of education and technical training, which increase their ability to use physical assets effectively.

Because of the enormous importance of thrift, if the aim in India is to catch up, as quickly as possible, with the standards achieved in, say, the United States, their leaders ought to make one of their top priorities the creation of great respect for thrift. This they can do most effectively by gradually discarding *discriminatory* taxation[1]; and that will mean avoiding one of the worst mistakes of the western powers during the present century. It is neither to the advantage of India as a whole nor of its poor if the provident are taxed for the benefit of thriftless, the industrious for the benefit of the lazy, the enterprising for the benefit of the complaisant or the plodder, or the competent for the benefit of the incompetent.

A case can, admittedly, be made out for death duties to limit the size of inheritances[2]. But, under economic democracy, this case rests on an important proviso. The sums acquired by inheritance taxes (or by any "progressive" element in taxation) must be constitutionally protected from squandering by the politicians. If the community's progress — through provision for the future — is not to be braked, the proceeds of death duties (or of the "progressive" element in taxation) must be *maintained intact and devoted to the production of income-yielding assets,* whether in the form of loans to private businesses, investment in equities *via* a collectively-owned investment corporation[3], or devotion to State enterprises[4].

Among the "assets" into which the proceeds of death duties or the "progressive" element in taxation *may* be legitimately invested are the people themselves. In so far as capital raised by discriminatory taxation is devoted to general and technical education which actually *does* play a part in raising the real earning powers of the people[5], the capital transferred may well be maintained intact. But a large proportion of expenditure on education will necessarily be in the nature of replacement. The developed powers of a person ultimately decline as he ages, and die with him. Hence some part of expenditure on education and training must, properly speaking, be regarded as in the nature of consumption and ideally be met out of *proportional* taxation (i.e., taxation which takes the same proportion from all incomes down to the point at which it does not pay to collect).

But increased expenditure from taxation on education may require concurrent or prior provision of additional physical assets from savings if that investment is to be fertile. And the skill of men not only need tools if they are to be productive. They require an appropriate development of communications (roads, railways, ports, etc). and trading institutions.

It is equally true that the accumulation of equipment may be wasteful unless accompanied by complementary investment in human capital.

In a stimulating recent contribution on this topic, Dr. H. D. Gideonse writes:

"If we ignore the fact that labour as a productive force derives its value from the investment of capital in the form of inservice training and formal education, it is impossible to understand comparisons of economic growth in the U.S.A. and in the U.S.S.R., or to develop an intelligent understanding of our experience with the Marshall Plan in Western Europe when it is contrasted with the disappointing result of our billions of foreign aid in Asia or Latin America. In Western Europe the 'aid' produced increases in productivity that were more than proportional. In Korea or Indonesia there was no measurable enduring response in productivity..........

"In the European case, our 'dollars' literally 'primed the pump' — a human pump consisting of trained and educated manpower with moral or customary attitudes that were compatible with development. In the Asian or Latin American cases the absence of the corresponding — or preceding — investment in the human factor doomed the venture from the beginning. The experience of Japan, which has shown an increase in productivity that is more than proportional to the flow of private capital assistance which it has received, is additional confirmation of the hypothesis that the rate of human investment is the crucial factor....

"In the under-developed countries educational policy is more easily recognized as a part of overall economic policy. The difficulty here is the emotional resistance to the acceptance of a rank-order of priorities that is compatible with a reasoned strategy of economic development. In the egalitarian passion for literacy which was encouraged by some of the less fortunate activities of UNESCO programmes for national literacy — the first six years for everyone — were sometimes encouraged at the expense of all other educational and economic development. Literacy at the sixth-year level is a not a reliable foundation for step-by-step articulation of a programme that supplies essential human skills as they are needed in the acceleration of economic development"[6].

To discern the potentialities of growth in a country like India, it is essential to appreciate that it is to the advantage of the *developed* countries that the economic progress of the *under-developed* countries shall be fostered. If there were no restraints imposed by the governments of the more advanced areas, the resources needed for the rapid economic expansion of the backward regions would flow into them far more rapidly than is happening at present. But most of the governments of the western world are committed to policies known as "central economic planning"; and among the aims which the "planners" nearly always pursue is that of retaining resources at home, or, as it is usually phrased, "preventing the outflow of capital". Now this discouragement of investment abroad is not to the material advantage of the people of any country which resorts to it; for resources (i.e., capital) are only sent to other countries when their prospective yield (i.e., their forecast contribution to the well-being of the nation) is higher abroad than at home. But the greater harm caused by restraint on the free international movement of capital is to the areas which, like India, are thirsting for capital. The economic and industrial progress of such countries has, indeed, been much slower than it would have been if the private owners of capital in Western Europe and United States had allowed greater freedom to seek profits, without restraint, in those areas of the world judged to be most productive.

Why do we know that the under-developed regions could attract so much of the savings (that is, the accumulating resources) of the western world under unrestrained private enterprise? The answer is that *setting under-utilised resources to work is nearly always the most fruitful form of investment.* When there are no restrictions imposed by governments, investors will find it profitable to supply both equipment and co-operating capital; and this will enable the world's markets not only to provide more remunerative employments for the masses of the poorer countries, but to create an incentive for training the backward peoples in more productive and higher paid occupations. It is not *altruism* which will have this result. The development of virgin resources (by which is meant undeveloped or under-developed factors of production) simply happens to provide the most remunerative of investment outlets.

Moreover, there are other factors which are tending to spread secondary industrial activities over regions in which they do not as yet exist, or are as yet only beginning to emerge. The more advanced industrial countries do not themselves possess sufficient resources (labour, skill, equipment and "gifts of nature") to supply the world with machinery, machine tools generally and other products for the manufacture of which they have *"acquired* advantages" (or special natural advantages) *and* at the same time to manufacture secondary industrial products cheaply enough to export. During the last few decades a new division of labour has been brought into being by these circumstances, and it is currently creating a strong propensity to industrial progress in countries where there are as yet no local secondary industries.

Unfortunately, this propensity has nowhere been allowed free scope. On the contrary, it has been resisted almost everywhere. For instance, under world freedom of trade a country in India's position (like many other economically under-developed countries) would probably have experienced incomparably more rapid industrial progress than it has in fact enjoyed. For had pure profit-seeking been permitted or encouraged, both by the governments of relatively wealthy countries with capital seeking outlets, and by the governments of the poorer countries wishing to raise their living standards, there would have been relatively little need for "aid" from other governments. Indeed, the advantage which the Indian people would have won from the new employment offered by private foreign investments would have been almost unbelievably greater than any benefits received from foreign governmental resources, or from World Bank loans.

Under existing circumstances, of course, foreign aid is not without material importance. But if international freedom for investment had existed, and the free market system had existed internally, the significance of "aid" would have rested firstly in the gesture of goodwill which it has expressed, and secondly in the possibility of its being utilised *educatively,* the sums advanced being maintained intact as "capital" (in which, of course, we must include "human capital"). Thus, if the immediate aim had been to provide Indian businessmen *with loans* to develop their enterprises, or directly with *risk-capital* (through some form of investment corporation), the fruits would have been commulative and the whole population would have shared in the results.

If there is one country in the world for which this could have been confidently predicted, it is India, which has a well established commercial class and an ancient trading tradition. In the writer's judgement, the aspect of industrial progress which is most important during the formative stage of any industrial revolution is the marketing — the buying and selling — aspect. Business (including industry) consists largely of continuously predicting changes in consumer demand for particular products and charges in the availability of means of production, together with action in response to such predictions. The response takes the form of business planning and budgeting. Through rational foresight of this kind, scarce capital resources are committed to specific uses for varying periods. The costs of particular "inputs" are incurred in anticipation of prospective prices of the corresponding "outputs". In a more enlightened world, "foreign aid" would have been primarily devoted to training business men in the art of managing this process simply by financing *private* business. That this has not been done has been due, firstly, to the governments responsible for "aid" not having understood the issues I have just been discussing; and secondly to the political aims which have motivated it.

Because the Western governments have wanted to discourage the countries assisted from becoming "communist", they have financed foreign governments rather than peoples. But governments are, after all, merely small groups of private persons; and they are all too apt to squander foreign aid, as well as their own people's savings in striving to maintain themselves in office. This does not mean that, given the existing political situation in the world, this political aim of the donors of aid has not been legitimate, or that it has not had some of its intended effects. But direct aid to private Indian profit-seekers would have meant far more to the impoverished masses in India. It would have raised the employment opportunities at their disposal, released incentives for the improvement of their powers, and silenced the cynical allegation that the supposed generosity of foreign aid has merely been bribery of governments.

It has already been suggested, however, that capital advanced in the form of gifts from friendly governments could never have been nearly as fruitful as capital advanced in the form of purely private investment under normal business incentives. It is now further suggested that the development potentialities of India would soon become a magnet to that part of the world's savings which is not being withheld by restraint on the export of capital, *firstly* if the Indian Government declared itself to be committed to economic democracy (i.e. private enteprise in business), and *secondly* if constitutional guarantees were somehow created to ensure that private foreign capital investments would be safe from confiscation by future governments (whether through nationalisation, taxation or other subterfuges). In the writer's judgement, fear of spoliation *via* the State is currently creating the most formidable *internally imposed* barrier to a rapid transition to industrial modernity and the high living standards associated with it, not only in India, but in most other under-developed communities.

But what of the fear that, the progress of these regions having been financed by aliens, we should ultimately find foreign ownership — with foreign control — of the greater part of the industrial assets of the countries financed? The answer is that a progressive economy would soon have its own savings to invest. Substantial investment from overseas is necessary in order to set going what has been recently called the process of "self-sustaining growth"; but subsequently, according to the extent to which thrift can be stimulated, a country such as India will be able to provide for itself a gradually rising proportion of the capital needed for its continued expansion.

During the transition to self-sustaining growth, direction from abroad represents the reasonable resolve of overseas investors, who are hastening the transition, to ensure the conservation and efficient use of their hard-won savings. Moreover as we have seen, "foreign control" may provide expertness in risk-taking, management and technical competence. Indeed, its presence may be expected to exercise a powerful educative effect. Whilst college courses in management can communicate recorded experience of business forecasting, budgeting and administration, and provide formal training in the relevant technical skills, real expertness in the decision-making of commerce and industry can be learnt only in action. What sentimentalists, or politicians appealing to sheer prejudice, may describe as "foreign domination" of industry can be the channel through which the most valuable copital of all can be transferred (from, say, American, British and German managements to Indian managements), namely, proficiency in prediction and the direction of business effort. There is not the slightest doubt in the writer's mind that Indians have *innate* tolent for the development of managerial ingenuity[5]. Their best opportunity of developing that talent may well be *via* co-operation with managements responsible to foreign investors. An attempt to learn it independently, through bitter experience (with some help from books and lectures), can certainly succeed; but will it not command success much more slowly?

One of the chief obstacles to the speedier modernisation of the industrial and commercial system of India is believed by some authorities to have been the absence there of an influence, sometimes called "the Christian ethic", which prevailed during the revolutionary growth in industrial output and trade in the western world during the eighteenth and nineteenth centuries. There are sociologists who hold that this phenomenon was ultimately attributable to attitudes toward thrift, interest, profits and amibition which grew out of the Protestant reformation—particularly among the Puritans. The moral approach of Protestants and Puritans towards trade and thrift has been somewhat misrepresented by certain historians and sociologists. But it is true that the religious convictions of the Protestants tended to justify the normally altruistic virtue of thrift, and did not frown on the incentive to excel and win respect — the personal ambition which promotes self-improvement and diligence.

Nevertheless, in the present writer's view, doctrinal teachings tend more often to support and propagate the morals of any era than inspire those morals; and the religious traditions of countries like India (however different from those of the West) need form no lasting obstacle to the development of a system which rewards persons whose providence, initiative and wisdom succeed in raising the material standards and broadening the economic life of the people.

Profit-reward (in so far as it is truly profit) is always small in relation to the social benefit for which it is the recompense. And rigorously envisaged, "profit" is merely a realised yield in excess of the date of interest upon the value of replaced or accumulated assets, just as "loss" is a realised yield which falls short of the interest return. In seeking to avoid losses (and this is the same thing as seeking profits) to the investors on whose behalf they act, business managements are responding to production objectives set by the people as consumers; for consumers have the power to buy or refuse to buy any product offered. The form of replacement of inventories consumed and equipment worn out (or otherwise depreciated) or of their net accumulation is determined, under the free market system, by society's democratically expressed preferences.

The rate of material progress of any under-developed area is likely to be closely related to the degree of economic democracy achieved. By "economic democracy" is meant *the vesting in the people, in their consumer role, of ultimate power to command and control the productive process.* Through the consumers' expression of their wishes in the market (in buying or refraining from buying), the possessors of skill and the owners of physical resources are discipplined, not by a few strong and privileged persons or groups (as under "central economic planning") but by the whole community. And the consumers' discipline is then exercised with the greatest direct force upon the business managers who most commonly — in the modern world of free enterprise — administer limited liability corporations. The managers act as intermediaries, entering into contracts with investors (as risk-takers) on the one hand and the suppliers of effort or skill ("labour") on the other.

The profits with which consumers remunerate wise prediction and action in business accrue, almost universally, to shareholders — those investors who are prepared to bear the risks of the managers making wise or unwise, lucky or unlucky decisions on their behalf. Investors contract to accept such risks when they acquire what are known as "equities" or "ordinary shares". There are social advantages in this sort of arrangement. *The suppliers of capital* cannot themselves have the detailed market and technical knowledge to make the necessary decisions with success, yet it is appropriate that they should bear the risk, thereby earning risk-remuneration (profit) as well as interest; for individual managers can seldom possess sufficient capital to justify their shouldering the essential risk-bearing function. Moreover, it is difficult, although by no means impossible, for "labour" — *the suppliers of effort and skill* — to bear the risk by paying interest to the providers of capital and sharing profits, in addition to wages as their remuneration[13].

It is important to perceive the democratic nature of the authority which business managers — ultimately subject to consumers' will—must wield on behalf of the risk-takers to whom they are legally responsible; for backward communities may be expected to advance in proportion to the extent to which the reasons for the responsibilities of the managers—in commanding and directing the productive process — are understood and respected. The orders of "employers", as it is usual to describe the managements of companies[14], are democratic because, as we have seen those orders are, properly observed, the interpreted dictates of the whole people in their consumer role.

Economic democracy is most likely to be achieved under political democracy. By political democracy is meant a society in which the rulers are elected, but accorded strictly defined, limited rights to make and administer laws. In every *true* democracy, it is not only possible to change rulers without force, but to subject them to enforce enforceable "rules for making rules". In a perfectly democratic society, a rigid constitution would strictly restrain the powers of the small groups of private persons who form successive governments. Thus, if political democracy has really been won, majorities will have no right to enrich themselves (through the government which they have elected) at the expense of minorities, or to discriminate in other ways, for instance on grounds of race, colour, creed, caste or social class.

There is, in fact, no such *perfectly* democratic governmental system in existence anywhere. But independently enforced constitutions, like that of the United States, provide example of the machinery through which true democracy would be obtainable if societies ever did wish to free themselves from State tutelage and vest sovereignity in the people. British democracy evolved on a foundation of strong traditions or "conventions" which limited the powers of the legislature and the executive. But political philosophers have now perceived that the constitutional effectiveness of those "conventions" has been quite inadequate against the forces of acquisitiveness and envy.

The virtues of democracy are, indeed, derived less from the franchise (the right of citizens to qualify, by educational achievement or other proof of competency, for the responsible duty of choosing legislators) than from independently enforced constitutional entrenchments which limit governmental power by invalidating discriminatory laws. Such constitutional entrenchments do not stand in the way of the assumption by the State of any truly co-ordinative functions. The difference between liberal[16] and totalitarian planning by the State is that, in the former, firstly, the democratic rights of the people as consumers (expressed through the market) are regarded as sacrosanct; and *secondly*, that no power to discriminate is conferred. But under totalitarian planning (as is found under what Mises has termed "omnipotent government"), not only is the market expression of consumers' preference overruled but the government (a small group of private people, we must always remember), through its officials, claims the right to discriminate in favour of one industry against another, or one district against another, one firm or person against another, and one class, caste, or race against another.

Most countries of which the industrial development is only just beginning assume that tariff protection of young industries is essential for their emergence or survival. There is an element of validity in this assumption; for foreign suppliers of goods which compete with domestic industries that are in process of establishing themselves may try to kill the infant industry at birth by price-cutting in that region alone. But legitimate protection in this case should do no more than prevent the price of the local product from being forced below, say, nine tenths of the previously ruling price. This is because the justification for establishing any local industry is that, by reason of cheaper labour — or other relatively under-developed resources — it is possible to produce the protected commodity substantially cheaper than the foreigner can, given his high costs of transport, insurance, interest and marketing. If you can establish a new industry at home only by raising the price which your people have to pay for its product, by doing so you will be holding back your country's development, not fostering it.

What misleads so many people is the fact that it is often possible to create prosperity for any industry, *considered in isolation,* by means of a tariff which excludes or restrains competing imports. But in each case *all other non-competing industries are burdened;* for when people have to pay more for one commodity they have less income left with which to demand other commodities.

Even in developed countries, the overwhelming majority of industrialists *believe* that the emergence of industrial activity, as well as its survival, depends upon protective tariffs. But the arguments by means of which, in the 18th century, Adam Smith exposed the fallacies in such ideas have never been refuted. No economist denies that import tariffs can benefit the people of a country if they enable them to exploit some monopolistic power which they happen to possess (either as sellers or as buyers). The use of such powers *can certainly improve what we call the "term of trade"* of a country; but this simply means obtaining a given volume of imports with a smaller volume of exports; and as no tariff protection programme has ever been designed to increase the volume of imports in relation to the volume of exports, the theoretically conceivable gain (through the exploitation of foreign suppliers or purchasers) is hardly likely to be realised in practice[17].

An illustration from the United States may be helpful. Over the last four decades, the southern states have been enjoying a phenomenal industrial progress. Now if these states had happened to possess sovereign independence, they would almost certainly have been forced to protect their "infant industries" against competition from the highly developed industries in the North. Under protection, because the forces tending to spread industry are extremely powerful, the southern states would have developed *some* industries; indeed, they would have been very proud of them; and they would have been convinced that they were the result of tariff protection. But because the American Constitution has denied these states unqualified political freedom, by forbidding the erection of import tariffs, there industries have grown and have diversified at a rate which has seldom, if ever, been surpassed anywhere[18].

The case of South Africa, which has also experienced remarkable industrial progress over the last four decades, provides another illustration. In spite of protective tariffs which have slowed down the development tempo, rapidly increasing utilisation of Coloured[19], Indian and African labour in factory employments has engendered an industrial boom[20]. Yet the writer has for many years told his students that every time he sees a factory in South Africa, he seems to see next to it a "ghost factory", that is, a factory which would have been there had not industrial growth been burdened by tariff protection.

It is sometimes argued that industry can be stimulated at the expense of agriculture. But although industrial protection undoubtedly does impose a burden on farming activity, in the long run it does not imply a redistribution of national income in favour of those engaged in industry and against those engaged in farming. It reduces all incomes, more or less in the same proportion.

Not only is it impossible to stimulate industry by any transfer of income from farmers to industrial investors, but a vigorous development of factory production nearly always requires a parallel development of agriculture. There is a certain complementarity in economic progress under which the growth of output in one sector creates demand for the growing output of another sector. It seems that what is wanted in India is a process which has been called "the industrialisation of agriculture" (i.e., its gradual mechanisation), accompanied by concurrent investment in modern methods of factory production.

But the technological improvement of agriculture is *likely* to mean that many small farmers will find that they can earn more as skilled farm workers than as small farm owners. One can well understand the feelings of those who would resist the sociological changes which such a revolution in agricultural methods and land tenure would cause. But if the Indian community are to be better fed (as well as better clothed, better housed, and better supplied with secondary industrial products), large-scale farms must supersede smallholders. On the other hand, Indians as a whole may wish to give a high priority to the preservation of peasant farming. If so, they must be prepared to sacrifice the possibility of a rapid development tempo in both agriculture and industry.

Although wise leadership by the State is essential for the progress of under-developed areas to economic maturity, there is always the danger that spectacular grandiose schemes will be given priority; for governments are, we know, tempted to choose projects for which they can claim early credit and prestige. Whereas private investors have obvious motives for avoiding any squandering of their capital, and equally strong motives for careful prediction and risk-taking, the people who form governments are actuated by quite different motives. They do not personally bear the losses nor reap the rewards, as do private investors. That is partly the reason why certain critics believe that the large sums invested in the Indian steel industry have not represented the most productive use to which the savings of the Indian people could have been put, at the present stage of their economic development.[21] There is a certain time sequence in successfully programmed growth — a sequence normally secured through the simple operation of the loss-avoidance, profit-seeking incentives.

It is futile, for instance, to direct the people's savings into heavy industry before the secondary industrial activities it can serve are emerging, the transport and communications system (roads, railways, harbours etc.) is being developed, marketing machinery is evolving, and the appropriate education and training of labour is proceeding.[22]

There is another way in which India may foster its industrial development, and that is by avoiding the blunders of the "developed countries" in the matter of labour's remuneration. In the western world, the course of politics has encouraged State action, or permitted private coercive action, continuously to reduce the flow of wages and other income. To understand this problem we must never forget that wages are paid by the consumers of the product, and neither by the owners of the businesses which employ labour nor by the managements of those businesses. Every increase in wage-rates which is enforced by privately-exercised coercive power (as through strikes) or by the State (in order to get the support of particular groups of voters) leads to the community having to pay more for the product. There are some exceptions to this principle but they are of negligible importance. The effect of such price increases is always "regressive," by which we mean that they tend to burden the poorer consumer relatively more than the well-to-do. Hence, in a society which wishes as rapidly as possible to raise its standards of living, and especially those of its poorest classes, wage-rates should be determined by free market forces. The flow of income and wages will then be maximised and its distribution rendered as equitable as possible.

The functions of labour unions should, in an equalitarian and economically democratic society, be confined (a) to preventing the "exploitation" of their members by firms which might rely upon ignorance about what the labour market is offering, or (*b*) to breaking down agreements to remunerate any group of workers by wage-rates which are less than the true free market value of the labour. In case (*a*) labour unions could search out better paid opportunities for members whom they felt were being under-paid through their unawareness of these opportunities; and in case (*b*), they could bring Court actions for the dissolution of combinations designed to force wage rates below their competitive level. But the right to strike means the right to use coercive power for private aims; and when the countries of the western world tolerate private coercion (whether in the form of strikes, boycotts or otherwise) they are submitting to a regime of right is might. Their ability to use and develop their physical resources and the powers of their people for the common good is obviously reduced thereby.

The great economic advantage which communist countries have in comparison with those of the West is that they do not permit strikes. This virtue of the totalitarian communities has naturally to be set against (*i*) their marked inferiority in the realm of management, (*ii*) the extraordinary clumsiness of their market machinery, and (iii) the absence of freedom of thought and expression under their system. But the peoples of the free world could have outstripped the communists in *every* direction if they had followed the Russian example in just this one respect, namely, denying the right of private coercion. If, say, the United States had, in this way, protected their working classes from the labour union activities which have all along been growing stronger, and forcing the flow of wages and income well below what it could otherwise have been (as well as destroying the *security* of distributive justice), not only would the prosperity and material standards of Americans have been even more impressive than at present, but those benefits would have been shared much more justly with the Negroes in all parts of the country.

Some of the most serious weaknesses of the western powers' contemporary economic policies are to be found in the sphere of money, and unfortunately these weaknesses have been copied by the governments of under-developed countries. Inflation, either in the sense of the depreciation of a nation's currency unit in terms of currencies in general or in the sense of its depreciation in terms of purchasing power, is proof of monetary inefficiency; for (to simplify the issue for expositional purposes), the purchasing power of the money unit is wholly a matter of discretion, determined chiefly by the relation between the volume of bank deposits *plus* currency in circulation (which volume can easily be controlled by treasuries and central banks) on the one hand and the flow of output on the other hand.

It is true that, if the performance of the State's role in the economic system is defective—prices and wage-rates coming to be fixed beyond the reach of the people's income, or out of harmony with their expectations so that unemployment emerges—inflation can serve as a crude way of bringing the economy into better co-ordination. But it has a debilitating effect, through penalising those who have been innocent of the pricing activities which have disco-ordinated the economy and encouraging those who have been responsible. Governments do not "fight inflation," as they universally claim. They engineer it however reluctantly, because it is often the politically easiest way out of their difficulties. And inflation will continue until electorates become sufficiently well-informed to throw out governments which resort to the debasement of their money.

Admittedly, the political difficulties of non-inflationary policies are real, and it would be too much to expect that an under-developed country should refuse to follow the depreciation of say, the American dollar, which is to-day the tacitly accepted monetary standard of the world. Nevertheless, a community such as India ought to realise that a continuously rising cost of living is a phenomenon which strong, wise and truly democratic governments could prevent; and they should reject the currently fashionable argument that "moderate inflation" is a tolerable method of boosting a flagging economy. That argument becomes plausible only when governments are failing in their duty to protect society from collusively or politically motivated sectionalist actions which are discordinating the economic system.

Not least of the evils for which inflationary policy must bear the blame is that, in attempts to prevent costs from increasing ahead of and in anticipation of price increase, resort to a proliferation of "controls" becomes unavoidable. The people's right to protect their interests through the free market is withdrawn, and a socially neutral market is replaced by the arbitrary decisions of officials. "Controllers" allocate foreign exchange, import permits and licences; and they dictate prices, rents and outputs. Now when officials thus acquire the power to create or destroy private fortunes, an inevitable inducement to bribery with a consequent weakening of business morals must follow. The fear or fact of public corruption can, indeed, provoke a malignant debilitation of the business incentives which can build up a healthy, expanding economy.

Mention has been postponed of one matter of overriding importance which, the author feels, may already be sufficiently understood by Indian leaders. The most successful achievements of economic policy can remain unrecognised if expanding real income is balanced, or more than balanced, by population growth. To win more satisfactory living standards demands not merely the accumulation of income-producing assets and the better utilisation of those assets: it requires that the number of mouths to feed and the number of bodies to clothe and house must decline, remain stationary, or increase less than proportionally to growing outputs. It is necessary to make this rather obvious point for the sake of completeness of exposition.

To sum up, the achievement in India of a rapid development tempo will, in the author's opinion, depend upon the success with which (*i*) thrift can be encouraged by a taxation system which does not discriminate against the provident; (*ii*) the foreign capital needed can be attracted by the creation of faith that nationalisation or confiscatory taxation will be avoided and by official acknowledgement of the reasonableness of foreign control of foreign capital accepted; (*iii*) enterprise generally can be fostered by explicit official recognition of profit as the reward for wise and responsible direction of productive activity; (*iv*) a climate of economic justice can be created through constitutional entrenchments whereby legislation or private agreements which discriminate on grounds of race, caste or income will be unconstitutional and void; (*iv*) a climate of economic justice can be created through constitutional entrenchments whereby legislation or private agreements which discriminate on grounds of race caste or income will be unconstitutional and void; (*v*) the temptation to distort the form of development by tariff or quota restraints on imports can be overcome; (*vi*) the mechanisation of agriculture can be hastened, so that the economies of large-scale cultivation can be won side by side with industrialisation; (*vii*) the political incentive to invest public capital in spectacular, grandiose schemes can be resisted and an appropriate time sequence in development permitted; (*viii*) the determination of prices, wage-rates and outputs by private coercion (as through strikes or boycotts) can be forbidden; (*ix*) inflationary policy can be renounced, a major incentive to corruption (which accompanies the repressed form of inflation) being thereby eliminated; and (*x*) unbridled population growth can be prevented.

1. It is conventional to describe taxation which discriminates against the higher incomes as "progressive taxation."
2. This case may be based on the feeling that it is unjust to allow a person to enjoy the advantage of an inherited income in the achievement of which he can have played no part. But the wife and children of a rich man must necessarily benefit from his wealth during his life-time. Is there, then, any compelling ethical reason why these benefits should end at his death? Or the case for death duties can be defended on the grounds that, **properly administered**, they may promote a larger measure of equality of opportunity.
3. The earnings of any such corporation should naturally be used to reduce the load of the proportional taxation required to pay for the services of the State.
4. Amenities like parks as well as "free" public utilities such as roads, bridges and sewers, may fall under this heading.
5. As distinct from expenditures on "education" aimed at conditioning people's minds, so that they are amenable to control in the interests of the politically powerful.
6. H. D. Gideonse, **College and University**, Summer, 1963, pp. 424-7.
7. The urgency of the situation created by an **apparent** threat from the militaristic, totalitarian imperialisms of Russia and China, bent upon world domination, seems, to have made it expedient for peace-loving and freedom-loving powers, like the United States and the western powers generally, to seek the favour of the governments of the backward areas rather than directly to assist the inarticulate and untutored people of those areas.
8. Indians in the Republic of South Africa have succeeded remarkably in the trading field, against the obstacles of governmental-imposed discriminations and powerful prejudice.
9. The industrial and commercial revolutions effected under **laissezfaire** capitalism brought not only rapidly improving health and living standards (better food, clothing and shelter) but greater scope for leisure, the elimination of the child labour which had characterised the pre-capitalistic age, and greater economic equality. These proud achievements were secured in spite of restraints from misconceived legislation and labour unions seeking sectional benefits. See Hayek (Ed), **Capitalism and the Historians.**
10. The historians and sociologists in question are, on the whole those who have been actively allied to the political parties of the Left. A dispassionate and scholarly treatment of the issue is H. M. Robertson's **Aspects of the Rise of Economic Individualism.**
11. Thrift is normally altruistic because the saver wishes to protect himself from becoming a burden on others in old age, or in the event of some unforeseen misfortune, and to provide for those near and dear to him—his family and successors. It is politicians appealing to mass envy and supidity who have tended to represent thrift as mere greed or acquisitiveness.
12. If the free market is overruled through collusive action to fix prices or wage-rates (or to limit particular outputs), the remuneration (in dividends or wages) certain sections of the community may be raised. But the increase of dividends, or wages achieved for the benefit of such privileged sections is

enjoyed at the expense of other recipients of wages and dividends. The share of "profits" in aggregate income is not increased thereby.

13. Or sharing losses as a deduction from wages.
14. The term "employers," as usually used, is extremely misleading. The true "employers" are the consumers. Corporations, administered by managers, are the employees most directly subject to the discipline of the market.
15. When political power happens to be the monopoly of a minority the right of the minority to discriminate against the majority is, of course, equally indefensible.
16. The term "liberal" is here used in its old, traditional meaning. But by reason of the many virtues which liberalism (in the sense of economic democracy, as I have described it) has manifestly brought the world, the totalitarians have found it expedient to appropriate the term. To such an extent has this tactic succeeded that, in the U.S.A. today, the word "liberal" has almost come to mean a mildly totalitarian-minded reformer. The so-called "liberals" hope to preserve the benefits which true liberalism has won whilst allowing the State the right to suppress the freedom of consumer preference and entrepreneurial judgement which has been the source of these benefits.
17. The theoretical case for the use of import and export tariffs and trade restrictions to improve the terms of trade of under-developed countries is, however, strengthened when similar controls are imposed by the governments of developed countries, or when cartels tolerated by those countries are in a position to reduce the prices of their purchases below the free market value. Defensive restraints succeed when they force the removal of restraints in markets served.
18. In order to slow down the rapid advance of the Negro South, in response to the wishes of the politically powerful labour union movement, it was necessary to enact minimum wage legislation to prevent the Negroes from under-cutting their initial inferiority in respect of background and industrial skill. But even so, the enforced free trade permitted the Southern states to advance at a remarkable pace.
19. The term "Coloured" in South Africa refers to half-castes.
20. See the present writer's **Economics of the Colour Bar,** (Institute of Economic Affairs, London, 1964).
21. These remarks are not inspired by any dogmatic, doctrinaire objection to State enterprise. For instance, in South Africa, the establishment in 1928, by State initiative, of ISCOR, a great steel corporation, appears to have been the result of wise foresight and sound planning. It has proved most successful and an important step in the country's industrialisation.
22. The need for large-scale cultivation and mechanisation in agriculture to accompany industrialisation, the need for the provision of physical assets to accompany increased investment in education, and the need for the development of communications and trading institutions to accompany both—all three needs illustrate the importance of an appropriate time sequence, with priorities carefully determined in the light of prospective yields.

6

"GROWTHMANSHIP" : FACT AND FALLACY

By

Prof. Colin Clark*

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INTRODUCTION

India, since Independence, has been engaged in an adventure of economic development. At the same time, economic growth is engaging the attention of all countries, both developed and developing. This is a new area in the theory of economics and contributions have been made by eminent international economists. However, there is no conclusive theory of development as such. Even such an eminent economist like Prof. Milton Friedman, of the University of Chicago, pointed out, while addressing a meeting of the Forum of Free Enterprise in Bombay, that with all humility the economists had to accept the fact that there was no standard formula applicable for all countries, under all conditions, for promoting rapid economic growth. He added, however, that one of the important constituents of economic growth is individual initiative and enterprise or what is commonly referred to as the system of free enterprise.

One of the eminent writers on Growth Economics is Prof. Colin Clark, Director of Agricultural Economics Research Institute at the University of Oxford, England. His contributions on the subject, as in many other fields of economics, have been original, refreshing and thought-provoking.

The Forum of Free Enterprise is happy to present to the Indian public this booklet entitled *"Growthmanship" Fact & Fallacy*. We are grateful to the Editor of *Intercollegiate Review* in which it originally appeared and to Prof. Clark for giving us permission to reproduce this excellent essay as a Forum booklet.

I hope that students of Indian economics, our planners and governmental authorities will benefit by a study of this publication.

A. D. SHROFF

PRESIDENT

Bombay.

To judge from the manner and frequency of writing on economic growth now, one might have thought that it was something which had only just begun to occur. This of course is nonsense; economic growth, in a number of countries, has been going on for a very long time. However, we must not fall into the opposite error, and think that economic growth is something which occurs more or less automatically. History shows plenty of examples of countries stagnating or relapsing economically, rather than growing. In the present day world there are at least four countries—Argentine, Chile, Indonesia and Spain—which, for different reasons, are now no better off economically than they were fifty years ago.

Adam Smith, who first made economics the subject of systematic study [1] when he wrote *The Wealth of Nations* in 1776, did have some ideas about economic growth. But it is true that the economists who came after him, for more than a century and a half, had remarkably little to say about the workings of the process of general economic growth which was so manifestly going on all around them, preferring to concentrate their attention on how particular industries grew or did not grow, and how particular prices, wages and profits were formed. These were important subjects; but they did wrong to neglect the problem of general economic growth. One of the consequences of this neglect has been that during the last twenty-five years when the world really has begun to think about the problem, there have been so many ill-considered and ill-informed ideas put into circulation. It is to cover some of these ideas that the word "growthmanship"[2] has been employed.

To define our subject matter, growthmanship may be described as an excessive pre-occupation with economic growth, the advocacy of unduly simple proposals for obtaining it, and also the careful choice of statistics to prove that countries with a political and economic system which you favour have made exceptionally good economic growth, and that countries administered by your political opponents have made exceptionally poor economic growth.

Right at the start we can face the central issue of growthmanship. There are many politicians, business men and professors who demand that we go all out for economic growth, even at the expense of persistently rising prices.

A situation of rising prices is very frequently described by the word "inflation"—even by professional economists who ought to know better. The use of this word, in most cases, is erroneous; and we should object to the misuse of words, here and elsewhere, not only out of respect for the purity of the language, but also because such misuse of words may carry dangerously muddled thinking in its train. The word "inflation" means an excessive enlargement of the supply of money. When this happens it nearly always leads to an increase in prices, sometimes very violent. The drastic increases in prices which occurred, for instance, in America at the time of the Civil War, and throughout the world at the time of World War I, could more or less be described as "inflations" in this true sense of the term. But it is quite wrong to apply this phrase to the increase in prices which took place in nearly all countries in the years following the World War II. Both our practical and theoretical knowledge of economics now indicate to us that such increases in prices are usually the consequences of an excessive general level of demand, which in its turn may arise from a number of causes. It is true that there are a number of countries, particularly in Latin America, where genuine old-fashioned inflation is going on, in the sense of grossly excessive additions every year to the money supply; and the consequences are very serious, and plainly visible for all to see. The slower but nevertheless persistent increases in prices which have been going on during the last twenty years in the United States and Europe can not be explained in these terms. Here, the actual increases in the supply of money have played a small part, in comparison with excessive demand. Indeed, when the general level of demand has been allowed to become excessive, a restriction of money supply will probably not serve to counteract it. Therefore the sooner the word "inflation" is banished from general discussion, or rather relegated to the description of those parts of the world to which it is truly applicable, the better it will be for our economic understanding.

In fact, the situation is becoming clearer to us already. The advocates of growthmanship certainly do have unduly simple proposals of obtaining economic growth, just by stimulating demand all round. When demand becomes excessive in relation to current capacity to produce, then prices rise.

But why not let prices go on rising? There are a number of objections, from the purely economic point of view. But taking precedence of all these are considerations of justice. There are a large number of people with fixed—or comparatively fixed incomes—who have certainly done nothing to deserve the vicious injustice of having the real value of their incomes persistently eroded away by rising prices. They include many of the poorest in the community, pensioners, widows and others. It is true that some old people and widows may own stocks or real estate, and be able to administer their properties so as to avoid any loss of real income through rising prices. But it is only those of a certain degree of sophistication, and with sufficient financial reserves to make possible the taking of risks, who can do this. It is the poorest who must perforce put their savings into insurance policies, savings banks and the like. Any economist or politician who deliberately commits himself to a policy of continually rising prices, and who fully understands the consequences of what he is doing is guilty of one of the meanest of all possible actions, namely, deliberately robbing the savings of the poor and the old.

Some will say that satisfactory rates of economic growth have usually been observed to have been accompanied by rising prices. Some such cases can be discovered; but to enunciate this as a general rule indicates a very selective treatment of the evidence. Satisfactory rates of economic growth were obtained in the nineteenth century by many countries, at times of stationary or even declining prices. Conversely, in much of Latin America, rapidly rising prices are accompanied by very poor rates of economic growth.

It is very difficult for any country, as things are now, to avoid some rise in prices; the contagion is bound to spread across its frontiers in its import and export trade with other countries; but there are a limited number of countries, such as Switzerland, Belgium and Japan which have maintained very satisfactory rates of economic growth in recent years, while keeping their rate of price increase substantially below that of their neighbours. (It is highly significant that these are countries where the proportion of national income taken by government expenditure and taxation is considerably lower than elsewhere).

The economist or politician who offers to trade away price stability in return for an expected higher rate of economic growth may end up by finding that he has lost both.

Economists have long shown a regrettable tendency to devote their attention to the problems of the recent past, at the expense of those problems which most urgently concern the contemporary world. The near-collapse of the American banking system in 1907, and the violent price inflations which accompanied World War I, both found economists unprepared. So economic thought in the 1920's and 1930's was largely concerned with banking policy and price stabilisation, when what the world urgently needed then was some remedy for unemployment and business depression. In 1935 Lord Keynes wrote *The General Theory of Employment, Interest and Money* advocating proposals which, had they been put into effect at the time, although rough and ready, would have done a good deal to mitigate the severe unemployment and business depression from which the world was then suffering (though the economic nationalism and additional barriers to international trade which the author advocated would have done considerable harm). But with the coming of World War II, this phase of extreme unemployment and business depression was over probably never to return, and many of Keynes's proposals became inapplicable. In the years after World War II, the world's urgent economic problem—even in the United States—was not unemployment and trade depression, but scarcity of capital equipment and inventories. During this period however most economic thought was violently Keynesian, persistently devising measures against the supposed threat of another great general depression. Keynes himself, in the last months of his life[3], protested against the vulgarisation of his ideas—"turned sour and silly, mixed with ancient errors"—by the "Keynesians".

The period of capital shortage came to an end in the United States about 1955, in other countries a few years later. But we still have with us a great deal of economic thought and writing based on the assumption that capital shortage is still the world's really urgent economic problem. This was the background which led to the formulation of "growth models". These are systems of algebraic equations, setting out to explain how the process of economic growth takes place, based on the implicit assumption that capital is the critically scarce factor and that any improvement in the supply of capital therefore is bound to lead to further economic growth in a more or less determinate manner.

The earlier "growth models", particularly those designed by Sir Roy Harrod in Oxford in 1939 and Professor Evsey D. Domar of Johns Hopkins University in 1946, were at any rate formulated in a period when there really was a critical shortage of capital. These and later models were accompanied by much apparently sophisticated analysis of the "multiplier" (whereby capital investment could lead to additional consumption) and the "accelerator" (whereby additional consumption could lead to additional capital investment). These are still widely taught, though we now know that these relations are much more intricate, and involve longer time lags, than is shown by the form in which they are generally presented.

So the idea is still with us that the key to economic progress is to be found in further capital investment. (The word "investment", as used in economics, is confined to the actual construction of plant, buildings and equipment, and the accumulation of inventories, which is by no means the same as the ordinary meaning of the word, namely the purchase of stocks, bonds, etc., which may or may not result in actual physical investment.)

First the designers of "growth models", and now governments and economists all over the world, have concerned themselves with the "capital-output ratio", i.e. the amount of additional output which is to be expected from each unit of capital invested.

That is easy to determine, the reader may say. The average return on capital is a little over 5 per cent. It follows that the "capital-output ratio" should be a little under 20.

But this reasoning is fallacious. A capital investment of $100 should, it is true, add $5-10 to the income of those who invested it. But that is not all that it has done. It has added a good deal to the labour incomes of those who work with it too. On the average, in the United States and in other advanced industrial countries, about 75 per cent of the net product of industry goes to labour (defined in the broad sense, including salary earners and working proprietors); and when there is an addition to national product, labour will take about three-quarters of this too. So it has been found that an addition to capital of $100 adds to national product some $25 or more for each subsequent year, of which about three-quarters goes to labour; so the "capital-output ratio" is four or less.

Many builders of "growth models" have made the mistake of estimating this figure too high. It was true that, on the evidence available until about ten years ago, it did appear to average 4, but now, for many countries, it is known to be considerably lower. In other words, our estimates of new capital requirements for economic growth can be revised downwards considerably from those that we held previously.

But many "growth model" advocates have made a worse mistake, which no one familiar with economic theory should have made. We may be able to ascertain fairly accurately the average capital-output ratio prevailing in a country at the present time. But we are quite wrong in assuming that the marginal capital-output ratio i.e. the ratio prevailing for *additions* to output and capital, will be the same as the average. It may often be very much less.

It used to be held that the capital-output ratio should increase as an economy advances. It is clear that the capital-labour ratio has increased; but some of the nineteenth-century economists, particularly the leading Austrian economist Eugen von Bohm-Bawerk, thought that the capital-output ratio must be continually increasing too. Like other doctrines once held but long since abandoned by the economists of Western Europe (a Labour Theory of Value was part of the doctrine of Adam Smith) this idea of the necessity of an increasing capital-output ratio became fossilised in Communist doctrine, and has led to great waste and misdirection of economic resources in

Soviet Russia. In the preparation of all its economic plans the Soviet Government has proclaimed as a cardinal principle that the output of capital goods must be raised more rapidly than the output of consumption goods. While this may have been the right policy on certain occasions of extreme capital shortage, its indefinite continuance in recent years has led to Soviet Russia accumulating increasing quantities of under-utilised capital equipment. It is very interesting to see that Academician Arzumanian, a leading Soviet economist, was permitted to attack this principle categorically in a 10,000 word article in *Pravda.*

It was not, however, until the 1930's that the idea of increasing capital-output ratio was seriously criticised by Western economists. Doubts were thrown on it by the American banker-economist Karl Snyder (author of controversial book called *Capitalism the Creator,* who seemed indeed rather surprised at his own findings) and the Swedish economic historian Gardlund, who found that in certain Swedish industries the capital-output ratio was then not very different from what it had been eighty years earlier.

A good deal of additional information is becoming available in this important field of capital-output ratios, and the specialist reader may consult the proceedings[4] of the 1957 Conference of the International Association for Research of Income and Wealth. But some very important ideas on this subject were put forward at the 1953 meeting of the same organisation by Professor Everett Hagen of the Massachusetts Institute of Technology, which subsequent experience has confirmed. He showed that countries with a comparatively sparse population spread over a wide area (e.g. Australia, Brazil, Norway) tended on that account to need rather more capital per unit of output than compact countries like the Netherlands (this important feature of the Netherlands economy had indeed been noted by Sir William Petty in the seventeenth century). Countries generously endowed with natural resources tended to require less capital than those who had to make their living the hard way, by manufacturing. In a comparatively early stage of its economic growth, a country has to make large provision for "social overheads," "indivisibles," "infrastructure" or whatever we care to call it, mainly roads, railways, harbours and other elements in the transport system, power supply, government buildings, the initial stages of industrialisation and so on. While these are being constructed, the capital-output ratio must rise quite rapidly. But once they have been constructed, further increases in population and production can take place with comparatively small additional capital requirements. The burden of "social overheads" is spread over a wider base, and the capital-output ratio falls. At a more advanced state of economic growth, as in the United States, a large proportion of the total demands of consumers is for services, most of which require a lower capital-output ratio than manufacture. Moreover, when we come to think of it, a great many of our technical and organisational improvements are more capital-saving than labour-saving: e.g. the saving of additional railway trackage by automatic signalling of rolling stock through higher average speeds, of cables by communications satellites, of inventory by better accounting and control procedures.

But Professor Everett Hagen has also made another very interesting point, namely that countries with rapid population growth require, on that account, *less* capital per unit of output than do more slowly growing countries. This is for a rather unexpected reason. In every country, some mistakes in investment are made, both by public authorities and by private investors. But in a rapidly growing country the prospects for being able to retrieve these errors, and to find some alternative use for the misinvested capital, are much better than in a slowly growing country. Rapid population growth, in Professor Everett Hagen's remarkable phrase, "absolves a country from almost all the consequences of errors in investment".

A favourite exercise with many writers on economic growth (and the present writer must admit to having tried it himself during the 1940's) is to take a country's percent per annum rate of population growth and multiply it by the supposed capital-output ratio. Thus if a country's rate of population growth is 2% per annum, and the capital-output ratio is supposed to be 4, the conclusion appears to follow that annual capital accumulation must be at the rate of 80% of national product if capital is to be provided to equip a growing population merely at the same rate as their predecessor. Such exercises, apart from their mistake in nearly always taking the capital-output ratio too high, also commit the error of assuming that the marginal capital-output ratio is the same as the average, in spite of the several good reasons given above for thinking that it is not.

One economist who has applied this idea in a big way, and attracted world-wide attention to his results, is Professor Walt Whitman Rostow (formerly of the U.S. State

Department), with his doctrine of the "take-off" into "sustained economic growth".[5] But the "take-off" is a half truth, at best. It does appear to be true, in very general terms, that countries at certain stages of their history do experience some acceleration in their rate of economic growth; but it does not come nearly as rapidly or violently as Professor Rostow, indicates: and the dates which he specified for the "take-off" in some countries will not stand up to criticism. Professor Rostow's fellow economic historians all seem to agree that the facts have to be very much forced to make them fit this theory. His idea that all countries, at the time of the "take-off", quickly raise their rate of net capital accumulation from 5 per cent to 10 per cent of national product is a purely theoretical idea, without any evidence to support it; indeed it seems most unlikely that this has happened, particularly over the short period of a decade or two which Professor Rostow hypothecates. The idea of the take-off is one which must be used very sparingly and cautiously, if at all.

While it is quite clear that a certain amount of capital investment is a necessary condition for economic growth, it shows a very weak logical sense to contend, as so many economists have done, that it is a *sufficient* condition, or that economic growth in any desired quantity can be obtained simply by investing more. There may be a good deal in the refreshingly original ideas expressed by Professor Hirschman of Yale[9] who contends that the scarce and limiting factor in undeveloped countries is not saving but enterprise. "An economy secretes abilities, skills and aptitudes needed for further development roughly in proportion to the size of the sector where these abilities are already acquired and where these aptitudes are being inculcated": and once efficient, able and enterprising business leaders have begun to appear, they do not find too great difficulty in obtaining the necessary amount of capital (so long as the government does not tax the business sector too heavily).

Let us return now to the problems of the more advanced industrial countries. Throughout Europe, although there may be demands for greater economic growth, unemployment is very low. Americans, on the other hand, have had to watch their percentage of unemployment creeping up, subject to the business cycle, but with each succeeding peak higher than it was before, so that it now stands at over 5 per cent even in the good phase of the business cycle. Must this not mean, many Americans ask, that our rate of economic growth has not been sufficient to keep pace with the rate of growth of our labour force? Would not some increase in the rate of economic growth put right the greater part, if not all, of our unemployment problem?

There is a principle of business so simple and obvious that it is sometimes in danger of being overlooked in the formulation of government policy namely that it is no use planning to produce more goods if you cannot sell them. It is government policy, and it may be more so in the future, to increase the spending power of the market, by tax remissions and in other ways. A large part of the total of unemployment however is among men formerly attached to steel, coal textiles and similar industries, or men who work in ancillary industries and services in districts primarily dependent on these industries. Market research makes it clear, if common sense has not already, that when Americans receive an increase in their spendable incomes, through tax remission or in any other way, they are going to spend little if any of this increase on steel, textiles, etc. It is improvements in engineering technique which have checked the demand for steel, so that steel sales now are hardly any higher than they were ten years ago, when the rest of national product was much lower. And people are not going to buy larger physical quantities of clothing, blankets, etc., even though they may spend more money on more carefully styled clothes. Certain industries, and districts, are going to remain depressed however much demand in general is increased, even if it is forced up to the point of creating definite labour shortages in other industries.

Apart from these specially depressed industries and areas, there is a serious problem in all other industries too, which has been forcefully pointed out by Professor (now Congressman) Clarence Long, namely, that industry now demands much more skill and education on the part of its workers than it did even a short time ago. There are a very large number of men who never acquired any skill higher than that described by the words "operative" or "process worker" who have been displaced by mechanisation, but who lack the skill to embark upon new work. For an increasing number of processes also, now employers prefer women, who may not be any better educated, but whose labour is considerably cheaper. There are also a very large number of unemployed coloured men, for the above and for other reasons. An all-around increase in demand might soon lead to dangerous and cost-raising shortages of particular types of labour, engineers, technicians, building craftsmen and so on, while still leaving a large body of the less skilled men unemployed.

On the other hand, there is no need to paint a completely pessimistic picture. Most American economists will agree that a slight increase in the average rate of economic progress is desirable and that it would serve to re-employ a certain proportion of those now unemployed—opinions differ as to how many. But it would be agreed by nearly all that such an increase must be planned very cautiously, and kept within definite limits.

Had this text been written a year earlier, it would have been necessary to devote some space to the then very widely held belief that the rate of economic growth in Soviet Russia was extremely high; and this constituted a justification for "economic planning." It is not surprising that the Soviet leaders should have made such a claim, scanty and inaccurate though the evidence was on which it was supposed to be based. What was surprising and saddening was to see how almost all economists and politicians in the Western countries believed it, most of all the Central Intelligence Agency of the United States Government. It is within the last three years that the publication of three large studies, by Professors Bergson and Nutter and Doctor Jasny respectively convinced everyone, including finally the C.I.A. itself, that this idea was mistaken, and that the rate of growth of productivity in the Soviet Union was in fact, in the long run, probably lower than in the United States; so that instead of rapidly overtaking the United States in productivity, which had hitherto been supposed to be the case, the Soviet Union was in fact gradually falling further behind?

We are still not in a position to give any simple answer to the question of how economic growth is caused. The present writer has been working in this field since interest in the subject began, in the middle 1930's and has written three separate versions of a long book entitled *The Conditions of Economic Progress;* but it still seems to him that real research into the subject is only beginning. We can however reach some negative conclusions, and dismiss some over-simple explanations. If we wish fully to understand how economic growth occurs, we shall probably have to go outside the boundaries of economics itself, and bring in considerations from sociology, politics, law and history.

"Economic growth has taken place in the dissimilar circumstances of England, the United States, Canada, Japan, Soviet Russia, South Africa and Nigeria. Economists have no special insight enabling them to reduce these different historical experiences in straightforward causal relationship between simple economic magnitudes. The economic development has been accompanied, among other things, by a heightened spirit of enterprise, by capital formation, by improvements in production techniques and by improvements in the economic qualities and productive capacity of labour. But it seems impossible to isolate any one of these as the inevitable prime mover in the process of economic development and change."

Most research in recent years has pointed in the direction of attaching greater importance to human factors in bringing about economic growth, rather than a mechanical application of formulae about capital or natural resources. The human factors which matter in determining whether any particular people is likely to be able to attain economic growth or not are sometimes called the three E's—energy, enterprise and education. Governments can play a substantial part in providing education; enterprise, with a few exceptions, is something which governments cannot provide; it is something which must come from individuals, and the best that governments can do is to refrain from taxing or regulating it too severely. As for energy, or the willingness to work hard, this is something which lies deep down in the character of the people, and has little to do with governments, except that this, too, can be destroyed by prolonged misgovernment.

The preoccupation with capital and particularly certain types of capital at that, as the crucial factor in economic development betrays (if we look at it more closely) a profound materialism of outlook. It is not surprising that it is found among Communists, and those who have been influenced by Communism. The late Mr. Nehru made a speech on this subject which was very revealing: "A number of textile mills is not industrialisation. It is playing with it. Industrialisation is a thing that produces the machines. It is a thing that produces steel."

A slightly hysterical note can be detected, as these costly economic fallacies are propounded. The present writer, at a conference of economists in India in 1961, was asked whether he favoured the building of more steel mills in India. His reply, that this was a problem in comparative religion, was received with sardonic amusement. But this intense preoccupation with the single commodity steel, indicates that steel plants are of sufficiently striking and sinister appearance to serve as temples for a new materialistic religion. The worship of steel began in Soviet Russia. It is unusual for the leader of a country to change his name, still less to change it to "Steelman", as Stalin did. Now the idea is spreading. As the Washington wits say, any newly developing country has four really urgent needs—a steel mill, a national airline, a six-lane highway and an invitation for the President of the country to address the Washington Press Club.

So far as there is a solid economic idea behind all this muddled and emotional thinking, it is that the country needs to be able to make its own capital equipment. This however implies the further remarkable superstition that much greater profits and monopoly powers arise out of the manufacture of capital equipment than out of the manufacture of consumption goods; which is not the case. Someone should have explained to Mr. Nehru and all the rest that some of the wealthiest countries, such as Switzerland, do not manufacture steel at all, finding it more economical to import it; and that even very large and wealthy industrial countries find that specialisation in the production of complex modern equipment is desirable, and that it is better for them to import a substantial proportion of their capital goods. Steel is a particularly bad product to take because technical improvements in engineering are so rapidly reducing the demand for it. Before long, the world is going to be littered with unwanted and obsolete steel mills, built at great sacrifices by poor countries suffering from emotional political leadership, with money which could have done far more good if it had been devoted to other industries.

We have been brought nearer to an understanding of the relative importance of capital and human factors in economic growth by an important piece of research undertaken by Doctor Aukrust, of the Norwegian Government's Statistical Bureau. Norway appears to have collected more thorough and precise information than any other country not only on the level of real national product back to the year 1900, but also on the inputs of labor and capital. So this gives him a long series of years for analysis. However, a year-by-year analysis, the routine procedure for an econometrician, would be worse than useless. The results would be greatly influenced by the phase of the business cycle, with the very varying degrees of utilisation of capital which go with it. If we want to analyse the productivity of capital we must average the figures in five-year groups, to smooth out the transitory influences of the business cycle.

Doctor Aukrust's results were striking. A 1 per cent addition to the labour force, all other things being equal, i.e. without any improvement in capital skill, organisation, etc., would raise national product by only 3|4 per cent. A 1 per cent addition to the stock of capital, all other things again being kept equal, would raise national product by only 0.2 per cent. Analysis of results for individual industries showed that Norway appeared to have suffered from over-investment in all industries except shipping. On the other hand, with labour and capital inputs unchanged, improvements in the intangible factors—education, skill, organisation, etc.—were raising productivity at the rate of 1.8 per cent per year, the greater part of the whole observed increase in productivity.

Similar results, though not quite so precise, were obtained by Professor Solow for the United States.

In considering the following table, it must be remembered in the first place that these capital figures exclude not only consumer durables, but also residences. In most countries the order of magnitude of the value of the stock of residences is about one year's national product, so the full capital-output ratio, including residences, will be higher by this amount than that given in the table.

TABLE I

Capital, national product and labour input

		Capital, excluding land, residences, consumer durables	Net national product at market prices	Labor input billions of manhours per Year	Capital output ratio
		$ billions 1950 purchasing power			
Argentina	1935	27.2	5.42	10.99	5.01
	1940	29.3	6.65	12.01	4.42
	1945	29.4	7.00	14.08	4.20
	1950	35.1	8.89	14.03	3.95
	1955	39.3	9.81	15.57	4.00
Australia	1947	15.2	7.95	6.66	1.91
	1956	22.1	10.72	7.34	2.06
Canada	1910	14.4	6.46	7.58	2.23
	1929	22.1	10.1	9.92	2.19
	1947	33.9	17.8	10.24	1.91
	1955	52.8	22.7	10.92	2.33
	1959	62.3	26.5	11.99	2.35
W. Germany	1913	50.0	19.3	33.9	2.59
	1929	60.3	20.8	36.4	2.90

TABLE 1—Contd.,

		Capital, excluding land, residences, consumer durables	Net national product at market prices	Labor input billion of manhours per Year	Capital output ratio
	1939	72.0	31.6	41.5	2.28
	1948	51.0	20.8	34.9	2.45
	1955	77.6	42.8	49.5	1.82
India	1949-50	45.3	26.9	277.4	1.72
	1959-60	61.5	35.7	315.6	1.72
Japan	1905	7.5	7.8	58.1	0.96
	1913	13.0	11.0	60.6	1.18
	1919	16.7	14.1	61.5	1.18
	1924	25.0	15.5	64.7	1.61
	1930	31.1	22.5	64.3	1.38
	1935	41.1	26.35	71.6	1.56
	1951	35.7	27.2	65.8	1.31
	1955	50.7	36.3	78.5	1.40
	1959	68.4	50.1	86.4	1.36
Norway	1900	3.85	0.65	2.93	5.92
	1929	7.60	1.39	2.85	5.45
	1939	9.10	1.92	3.07	4.75
	1948	9.33	2.36	3.24	3.95
	1954	12.38	2.84	3.38	4.35
	1958	15.64	3.63	3.12	5.03
United Kingdom	1929	81.0	37.6	44.1	2.15
	1938	91.0	44.0	47.6	2.07
	1953	104.5	56.1	53.4	1.86
	1959	134.2	65.3	55.5	2.06
U.S.A.	1899	125.9	50.4	78.7	2.50
	1909	188.8	85.7	95.8	2.20
	1919	249.4	108.9	97.8	2.29
	1929	335.9	149.3	112.2	2.25
	1939	331.3	155.8	100.0	2.13
	1949	411.4	240.7	127.1	1.71
	1955	501.5	322.8	133.0	1.56
U.S.S.R	1928* / 1940	34.4(a)	48.9 / 79.9	155.0 / 205.1	1.11(b)
	1940 / 1948	not known	79.9 / 78.4	205.1 / 199.7	not known
	1948 / 1953	54.5(a)	78.4 / 105.9	199.7 / 214.9	1.98(b)
	1953 / 1956	53.6(a)	105.9 / 119.5	214.9 / 229.8	3.95(b)

* Adjusted to present boundaries.
(a) Increases in capital between these years.
(b) Increases in capital per unit of output between these years.

Some readers may at first sight be surprised to learn that the value of a country's stock of housing is only about one year's income. But young men buying houses, with the prospect of many years of earning income at an increasing rate before them, still find it unwise to spend more than two years' income on a house (for if they do, the annual payments, including taxes and maintenance, may rise to over 20 per cent of their income). A great many older people live in depreciated houses with appreciated incomes. In fact the ratio for the whole of the United States is now below one year's income as the depreciated replacement value of the present stock of residences.

In looking at figures for the 1930's it must be remembered that almost every country suffered severely from unemployment and also from under-utilisation of its stock of capital at the time. The capital-output ratios for this period may appear anomalously high because of this under-utilisation.

The capital-output ratios seem to be exceptionally high in Norway and the Argentine, both sparsely populated countries, requiring a very expensive transport system. Canada, which has to produce and transport agricultural and forest products and minerals over great distances, and also has many industries dependent on huge supplies of electric power, is also a capital-intensive country, and indeed appears to be one of the few countries where the capital-output ratio is increasing. Japan clearly has been remarkably economical of capital, even more than India.

One cannot fail to be impressed by the remarkably low capital-output ratio in the United States, with the prospect that the marginal ratio may be even lower than the average. It is in fact substantially below that of many European countries.

There have been widespread statements in Britain, from a great variety of sources, to the effect that the low level of British productivity is due to inadequate capital investment; it has been said that if British industrialists had invested at the same rate as American or German industrialists, productivity would have been much higher. This view was thoroughly demolished by Professor Barna.[12] He showed that the capital-output ratio in manufacture was in fact much the same in the United States, Germany and Britain. He also showed that, between 1948 and 1956, the amount of investment in manufacture in Britain was actually more than in Germany (populations of the two countries being approximately the same). The main difference was that "the investment pattern of Western Germany is more appropriately adapted to the changing needs of world trade...we put some of our money on the wrong horses." It is enterprise and managerial skill which matter, not the volume of capital investment.

The final section of this essay might be described, in a certain sense, as an anti-climax. After Dr. Aukrust's careful analysis of the Norwegian figures, and the extensive figures for other countries quoted above, it is going to be very difficult for anyone seriously to contend that increased investment is a sure way of increasing the rate of economic growth.

However, there are many people, in responsible positions, who do not reason in this way. They reason in a simpler manner altogether. The procedure is to construct what is sometimes called a 'League Table', ranking countries according to the percentage of their gross national product which they devote to investment; and then to set out to show that their position in this table is related to their rate of economic growh.

There are very many examples which could be quoted of this form of reasoning. We may take for discussion one publicised[13] by a highly responsible person, Governor Nelson Rockefeller no less, a spokesman for the Liberal[14] wing of the Republican Party. Governor Rockefeller sets out his claim that 'high investment and rapid economic growth go hand in hand' in the form of a diagram.

The diagram relates average per cent per annum rate of growth of real gross national product 1950-57 with 'Percentage Investment in Gross National Product'. The period over which this investment is measured is not stated; in the table below which follows it is calculated for the period 1950-56.

TABLE II

	Gross domestic investment as of gross national product mean of 1950-56	Rate of growth of real gross product 1950-57 % per year	Rate of population growth 1950-57 % per year	Real product per head 1950 divided by 1938
Argentine	19.8(a)	1.7	2.1	1.68
Australia	29.3(b)	2.6(c)	2.4	1.48
Austria	21.4	6.4	0.1	1.15
Belgium	16.1 R	4.0	0.5	1.13
Brazil	15.9 R	5.9	2.4	1.15

TABL II—Contd.,

	Gross domestic investment as of gross national product mean of 1950-56	Rate of growth of real gross product 1950-57 % per year	Rate of population growth 1950-57 % per year	Real product per head 1950 divided by 1938
Canada	24.7 R	4.7	2.8	1.61
Ceylon	10.9	3.5	2.5	(d)
Chile	9.9 R	3.1	2.3	1.04
China (Taiwan)	17.3(a)	7.5(e)	3.7	(d)
Denmark	18.9	2.5	0.7	1.10
Finland	25.4(g)	5.6(f)	1.1	1.20
France	18.2 R	4.6	0.7	1.31
West Germany	23.5 R	8.4	1.0	0.74
Greece	16.4	7.8	1.0	0.81
Guatemala	12.1	4.6	3.0	(d)
Honduras	15.6	5.0	3.1	(d)
Ireland	14.6	1.1	0.4	1.26
Italy	20.3 R	5.5	0.5	1.25
Japan	27.5 R	8.3(c)	1.3	0.85
Luxembourg	23.3	6.3	0.8	(d)
Mexico	17.8(i) R	4.7(h)	2.8	1.58
Netherlands	23.8 R	4.5	1.2	1.09
New Zealand	23.8	1.5(c)	2.3	1.31
Norway	31.1(j)	3.2	1.0	1.19
Peurto Rico	18.2	4.0	0.4	1.81
Sweden	20.6	3.7	0.5	1.37
United Kingdom	14.8 R	3.3	0.3	0.96
United States	18.2(k) R	3.6	1.7	1.60
Venezuela	23.9 R	10.9	3.0	(d)

(a) 1951 to 1956.
(b) Investment figures inflated by inclusion of private motor cars.
(c) My estimate.
(d) Not known.
(e) 1952 to 1957.
(f) 1952 to 1957: price change of consumption assumed applicable in other sectors.
(g) Excludes investment in stocks of commodities.
(h) 1950 to 1955.
(i) 1952 to 1956.
(j) Investment figures inflated by inclusion of repair work.
(k) Investment figures understated through exclusion of public investment.
R 'Rockefeller Countries'.

Governor Rockefeller's data appear to have been obtained from the United Nations annual reports on National Accounts Statistics. The above Table covers all the countries for which useful data can be obtained (supplemented by independent calculations of the rate of growth of real product in Australia, New Zealand and Japan).

Two other columns show further facts which should have some bearing on rates of growth. That Germany and Japan, for instance, in 1950 still had real national products well below the 1938 level is, quite apart from anything else, a reason for expecting unusually rapid growth after 1950. Conversely, in the United States and some other countries, where national product by 1950 was already very much above the 1938 level, we should naturally expect only a normal rate of growth after 1950.

The fact that Canada and the Latin American countries have high rates of population growth also gives us some grounds for expecting higher than normal rates of growth of real product in those countries; conversely with the low rates of population growth in Britain and Belgium.

In Chart A, the countries selected by Governor Rockefeller are shown in the positions which he gives, even though the data in the table differ (in Venezuela in particular, which does a lot to help establish his apparent relationship, the rate of investment has been much lower than he claims.) The other countries for which information is available, not included in Governor Rockefeller's diagram, are shown in Chart B. It is particularly interesting to see that the Scandinavian countries, Australia, New Zealand, Argentina and Ireland, all countries with a considerable measure of government regulation of economic affairs, have thereby achieved a high rate of investment—but have unusually little economic growth to show for it.

The inclusion of these other countries in Chart B knocks Governor Rockefeller's conclusion to pieces: it might almost suggest that a high rate of investment goes with a low rate of economic growth. Was their exclusion accidental, or a skilful piece of growthmanship? Or, if Governor Rockefeller is not responsible for these conclusions, has he been relying too much on his expert advisers?

KEY TO CHART

Rockefeller Countries (in circles)

1. Chile
2. Panama
3. U.K.
4. Brazil
5. Mexico
6. U.S.A.
7. France
8. Belgium
9. Italy
10. Germany
11. Netherlands
12. Canada
13. U.S.S.R.
14. Japan
15. Venezuela

Additional Countries (in squares)

16. Argentine	24. Gauatemala
17. Australia	25. Honduras
18. Austria	26. Iceland
19. Ceylon	27. Luxembourg
20. China (Taiwan)	28. New Zealand
21. Denmark	29. Norway
22. Finland	30. Puerto Rico
23. Greece	31. Sweden

SUMMARY AND CONCLUSIONS

Economic theories and 'models' of growth, formulated during the post-war period of capital shortage which attributed growth to investment, are now out-of-date.

It is more correct to say that capital is created during growth than that growth is a creation of capital.

The principal factors in economic growth are not physical but human. Human factors develop steadily but slowly.

Attempts by governments to force the pace may waste capital and end by retarding development.

Economists have gone wrong by misapplying in a period of over-employment, a theory designed by Keynes to maintain employment by investment in a period of chronic unemployment.

Even economists who have allowed for full employment have gone wrong by exaggerating capital as a source of growth.

We must not neglect the wisdom of the classical economists who saw that the agents of production are land, labour, capital and enterprise; neither economic theory nor recent experience provides support for the view that one factor takes absolute precedence over the others.

Dependable statistics of investment and growth are difficult to collect and even more difficult to interpret.

The best available figures suggest that the amount of capital required per unit of output can *fall*: this does not support the fashionable view that growth of output depends on further investment.

Recent evidence from a number of countries suggests that additions to investment have yield disappointingly small additions to output, the conclusion therefore seems to be that the rise in productivity has been predominantly due to 'human factors': better knowledge, organisation, skill, effort, education, enterprise.

International 'league tables' ostensibly designed to show that high investment and rapid growth go hand in hand do not bear examination.

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1. The distinction of being the first economist should go not to Adam Smith but to Sir William Petty, who wrote in the 17th century. Petty's writings contain some extremely valuable ideas and information. But even his warmest admirers (of whom the present writer is one) would agree that he did not attempt to set out the whole subject in a systematic manner, as did Smith.
2. The present writer does not claim originality for this word, which appears to have originated in the United States. The tracing of its first use might some day form an interesting subject for a minor research project.
3. "Economic Journal", June 1946.
4. Published by Bowes & Bowes, Cambridge, England.
5. First systematically enunciated in "The take-off into self-sustained growth," Economic Journal, 1956.
6. **The Strategy of Economic Development**, 1958.
7. Testimony to this effect was submitted by the present writer to a U.S. Senate Committee in 1960 and published in 1961 under the title "The real product of Soviet Russia" (U.S. Committee on the Judiciary). This however rested on much less substantial evidence than the three books cited above.
8. Bauer and Yamey, **The Economics of Underdeveloped Countries**, Cambridge University Press, 1957.
9. Quoted in **Freedom First**, Bombay, October 1960.
10. English text published in **Productivity Measurement Review**, Organization for European Co-operation and Development, Paris, February 1959.
11. The capital-output ratio in Norway in recent years, measured at Norwegian prices, has been about 3.5, so the marginal rate of return on a capital investment should average 20|3½ or 5.7 per cent. (This capital-output ratio of 3½ is much lower than the figure given in the main table, where all capital stocks have been valued at U.S. prices; in Norway, and for that matter in most other countries, building costs are lower, relative to U.S. costs, than are the costs of most other goods, and services; so valuation of capital stock at U.S. prices makes it appear larger.)
12. **The Banker**, April 1957 and January 1958.
13. Published by Governor Rockefeller **inter alia** in Governor's Conference on Automation, June 1, 1960 (State of New York). It has been very widely quoted elsewhere.
14. Liberal in the American sense of the word, i.e. favouring more state regulation and expenditure, or the exact opposite of European liberalism.

7

ECONOMIC GROWTH

By

Prof. Colin Clark*

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I

POPULATION AND ECONOMIC GROWTH

Rapid population growth in India did not begin until the 1930s. For the previous century or more population growth had been slow; likewise the rate of economic progress. Since 1950, the rate of growth of real national product has been considerably faster than the rate of growth of population, and (subject to erratic variations from year to year due to the weather) real income per head has been increasing at the rate of 1.5% per year, a rate much more rapid than in any previous period.

This of course does not necessarily show that there was any causal connection between population growth and the acceleration in the rate of growth of real product per head. The attainment of national independence in 1947 may have played an important part in stimulating national vitality, in the economic as well as in other spheres.

What is true of India however also appears to be true of the developing world as a whole. Population growth throughout the developing world, as in India, did not begin until quite recently. It was brought about, not by any increase in fertility; but by improvements in medicine and reduced mortality. Almost without exception every developing country during the last two decades has shown a rate of growth of real national product per head much faster than before.

National Accounts of Less Developed Countries, published in Paris by the Organisation for Economic Cooperation and Development (a very reliable international organisation) shows that the countries where population growth is less than 2% per year have an average rate of growth of real product per head of 1.4% per year. The next group of countries, which includes India, in which the rate of population growth is 2% to 3% per year, has an average rate of growth of real product per head of 2.3% per year. Finally we have a group of countries with rates of population growth over 3% per year, including many Latin American countries, but also Taiwan, Philippines and Cambodia in Asia. These countries have an average rate of growth of national product per head of 2.2% per year.

These international comparisons indicate that a rate of population growth up to 3% per year is at any rate not incompatible with high rate of growth of real product per head, and may indeed help to create it. In India the present rate of population growth need not be a cause of concern, though a rate of about 3% per year might be.

It has been shown by economic theory, and confirmed in fact by international comparisons, that population growth increases the proportion of national product saved, because it increases the proportion of young men, who are the most active savers, in the population, and keeps the proportion of old men low. This is strikingly true in India, where the Reserve Bank estimate of net savings, expressed as a proportion of net national product, rose from 5% in the early 1950s to 9% in the 1960s (excluding the recent drought years).

Population growth not only increases savings, but also makes possible the more economic use of capital, by spreading the overhead cost of large indivisible items such as the transport system over a larger number of people. Misplaced investments, whether public or private, under conditions of stationary population are likely to be a dead loss, whereas with an increasing population some remunerative use should eventually be found for them.

To an agricultural population with a limited amount of land which they cultivate by traditional methods, population growth undoubtedly creates hardship, which falls most severely on the poorest families. It appears to be the case however, judging not only from the evidence of the present day world, but also from historical experience, that population growth may be the only force powerful enough to compel such a community to seek newer and more productive agricultural methods.

In the past, the rate of population growth for the whole human race has been generally very low, and periods of rapid population increase rare events. Such historical periods of rapid population increase of which we have knowledge however are seen to have generally been accompanied by great advances, political and cultural as well as economical. Such cases were the ancient Greeks, the Dutch in the 17th Century, the English in the 18th Century, the Japanese in the 19th Century—and, I believe, the Indians now.

II

TAXATION AND ECONOMIC GROWTH

In designing a system of taxation three principles have to be observed. First, administrative practicability, secondly, economic efficiency and thirdly, social justice. The meaning of the first is clear. Economic efficiency refers to the effects of taxation in either improving or harming the quantity or quality of the national product. The phrase "social justice" requires careful definition. It must not be interpreted as some politicians like to use the phrase, to mean simply taking money away for those of whom one does not approve, and giving it to those whom one thinks will vote for one at the next election. Individual justice means that each man must respect the rights of other men, and social justice means that social groups, wage workers, farmers, employers, property owners, house owners, governments, must also respect each others' rights.

In practice we find that these three principles often point in quite different directions, and it is a very difficult task for the statesman to reconcile them. Economic efficiency could be promoted by severe taxes on the necessaries of life, such as the old Indian Salt Tax, or the poll tax on all tribesmen imposed in Africa, deliberately designed to compel them to go out and engage in wage-labour; but such taxes are not compatible with social justice.

Progressive taxation, that is to say, taxes which take a large proportion of income from the higher incomes than from the lower, is a justifiable policy, but it should be pursued in moderation. The present exceedingly high Indian marginal rate of taxation (that is to say the proportion of each additional rupee earned which is taken in taxation) at the higher income levels is harmful. On grounds both of efficiency and of justice it should be reduced to 50% at the maximum.

Indirect taxation (excise, sales tax and the like) on the other hand is usually regressive, i.e. falls relatively more heavily on the poor than on the rich. For a country to rely primarily on direct taxation is more in accord with social justice. But the only countries which in fact are able to do this are the two wealthiest countries in the world, United States of America and Sweden. All other countries have committed themselves to expenditures which cannot possibly be financed by direct taxation alone, and so have had to resort to large indirect taxes, which mean in effect more taxation of the poor. In India indirect taxation has risen from 65% of the total tax revenue in 1950 to 75% in 1966.

For these reasons alone, government expenditure should be kept strictly within limits. Taxation at the rate of 50% on the highest individual incomes, and 25% on the national income as a whole, should be regarded as the safe upper limits. The idea of the "Welfare State," defined as that state of affairs in which the citizen looks to the State to provide all his family's welfare needs, is an impossible dream, even in wealthy countries.

In India, defence expenditure now takes 4% of the entire national product. There is no point in deceiving ourselves. The world situation is threatening, and there is no prospect of reducing this figure, which may indeed have to be increased. Public expenditure on education now takes 2% of the national income, and there is also substantial private expenditure. These expenditures also will have to be increased. In education the government's function however should be to supplement private expenditure, not to bear the entire cost.

The provision of defence, internal law and order, roads, water supply, public health, and some help to education, will fully tax the resources, both financial and administrative, of any responsible government. All other activities, including industrial projects, housing, insurance and welfare services should be left to the private sector. Wealth Taxes provide substantial revenues in the Scandinavian countries. This is a good tax on all three principles, though the Indian rates are too high. Moreover, when wealth is directly taxed, Estate duties, Gift Taxes, and discriminatory income tax rates against investment income, all of which are severe deterrents to saving, should be abolished.

Experience in other countries has shown that sales tax at the manufacturing and wholesale level can be imposed at high rates without serious evasion, though at the price of some economic inefficiency. At the retail level however any rate over 4% is likely to lead to serious evasion. Most European countries are now converting their sales taxes into a new form of taxation developed in France, namely, the Value-added Tax. This tax, which in France has almost replaced the Income Tax, is imposed on the gross sales of all manufacturers and traders from which they may deduct costs of materials and depreciation, but no other expenditure. Such taxes thus give a strong incentive to economise on labour, office expenditure, entertainment and the like and thus promote economic efficiency.

If such a tax was imposed in India it might be desirable to allow labour costs as a deduction also. The administration of this tax is far simpler than the administration of the Income Tax. Indeed it has proved almost too easy in France, which now collects a higher proportion of the national income in tax than any other country (though India has the distinction of having the highest rates of taxation on individual incomes).

The principle of the tax payer being able to make an untaxed annuity deposit of part of his income is good, though the Indian rate of interest is too low, and under Indian conditions the Government ought to guarantee repayment adjusted by a price index designed to maintain the real value of the deposit.

In the present time of food shortage, it is probably desirable that income from agriculture should be untaxed, in order to encourage additional production. However, the present move to abolish what is left of Land Revenue charges (on this policy the parties of the Right and of the Left seem to be in agreement) should be reversed. Political difficulties will no doubt be very great; but the economic needs of India require the imposition of a high land tax, fixed on the capacity of the land, and not raised if the farmer succeeds in obtaining greater output; but the tax should vary with the price of grains. This form of taxation gives the farmer the strongest incentive to produce more; or, if he is unwilling or unable to do so, to sell or lease his land to someone who can. Such a tax would immediately and heavily reduce both the prices and the rents of lands, and would be frantically opposed for that reason. However Government might find it possible, as a beginning, to impose a tax on the larger land holdings, and later extend it to all land.

A practical means of assessing such land taxes has been demonstrated by long experience in Australia. The assessor first values the property, rural or urban, for what it would sell at in its present form. The tax payer can then indicate all the improvements made to the land, by his predecessors as well as by himself, not only buildings, but also drainage, wells, fencing, land improvements, etc. These improvements, subject to depreciation, and then re-expressed at present day values are deducted from the gross assessment. The remainder represents "unimproved value of the land" on which tax has to be paid.

The imposition of an extremely heavy land tax, taking at that time nearly half of the total product of rice lands, by the Emperor Meiji in Japan in 1873, just at the beginning of the industrialisation of Japan, played an important part in increasing agricultural productivity, in spite of the very small average size of farms. This was a necessary condition for Japan's subsequent rapid industrial progress.

All public expenditure should be decentralised as much as possible. No function should be undertaken by the Central Government if it can possibly be performed by a Municipal or District Government. Also it is entirely wrong to finance such governments by shared revenues or subsidies. Each level of government should be required with very limited exceptions, to raise the entire cost of the functions which it undertakes by taxation imposed upon its own electors. Only in this way will government decisions be made with a real sense of financial responsibility, and expenditure be confined to what is really necessary. Mismanagement and corruption are more quickly detected under these circumstances.

III

CONDITIONS OF ECONOMIC GROWTH

In the early stages of economic development, economic growth is generally measured by real national income (i.e. national income after allowing for price changes) per head of population. In India it is not at present possible to record precisely how many people there are in the labour force, or the average hours which they work. In industrial countries these factors are also taken into account, and economic growth is measured by real product per man-hour worked. The rate of growth of real national income per head may therefore be lower than the rate of growth of real product per man-hour, to the extent that the country works shorter hours, or releases workers from the labour force for retirement, education, etc.

Until the 19th century economic growth everywhere in the world was very slow. By the mid-19th century, Britain was showing a rate of growth of real product per man-hour of 1.6% per year, probably the highest in the world at that time. (All figures quoted below, in this and the following paragraph, refer to annual rates of growth of real product per man-hour). By the late 19th century, the United States (starting from a higher level than Britain) and France (starting from the lower level) were showing growth rates of 2.2% and 2.3% respectively. Japan about 1880, when accurate information first becomes available, had already attained a figure of 2.4% and between 1910 and 1930 attained a rate of 4.5%, the highest in the world at that time. At this time Japan's population was still rapidly increasing.

Since 1950 there has been a marked acceleration of growth in several countries. The figure is now 4.10% for Sweden, 4.2% for France, 4.5% for Germany and 4.6% for Italy. Japan again leads the world with 6.6%. The Japanese plan, announced in 1961, to double the national product in ten years, will probably be attained. During this period the United States however has adhered firmly to its old rate of 2.2%. Canada and Australia have similar rates. In Britain, after several decades of low and uncertain growth, the rate since 1960 has risen to 3.2% in spite of complaints to the contrary. Soviet Russia's rate is 2.0%, lower than that of the United States. Instead of overtaking the United States, Soviet Russia is gradually falling further behind.

The rate of growth of real national income per head in India is 1.5% per year, and about 2.2% for the developing countries as a whole. There are indications that these rates tend to accelerate once a certain level of industrialisation has been reached, as in Taiwan, South Korea and Mexico, which show 3% or more. To raise Indian production per head to the United States level would require a rise in agricultural production less than threefold, in manufacturing production more than thirtyfold.

One of the basic laws of economic growth is that we must expect a decline in the relative importance of agriculture. We may expect India in 20 to 30 years' time to be predominantly an industrial country. We cannot however force the pace, as recent experience has shown. As has been demonstrated by the experience of Japan, an improvement in agricultural productivity is a prior requirement for industrial advance. (A later section of this text indicates the measures necessary to increase agricultural productivity in India).

It has been held that economic growth depends primarily on capital investment, and much of Indian planning has been based on this assumption. Attempts have been made to prepare international comparisons to show that a country's rate of economic growth is related to the proportion of national product invested. But this theory breaks down when the information is thoroughly examined. Capital investment is quite frequently misplaced. Further, experience has shown, as in Japan, that industry can be developed on considerably smaller capital investments than were previously thought necessary. Much modern technology is capital-saving as well as labour saving. Capital investment in industry is necessary and desirable, but it does not occupy the dominating position previously supposed.

In our search for the dominant factors, in economic growth we have to go outside the field of economic into the regions of sociology and politics. Three words which begin with the same letter—Energy, Enterprise, Education—seem to indicate the principal factors at work. Energy refers, not to mechanical power, but to the physical and mental energies of the people, which have their sources deep in the national history and character.

Enterprise means the willingness to risk one's own money (not some one else's money) in innovations. In developing countries enterprise is probably the scarcest of all scarce resources, more so than capital. Economists who have made a close study of this problem, Everett Hagen and Hirschmann in America, Streeten at Oxford, have all come to the conclusion. namely, that the policy of "balanced growth" is mistaken; a policy of "unbalanced growth", leading to windfall profits in many unexpected quarters, is more likely to promote enterprise.

There is no doubt about the economic value of Education. The Indian educational system is seriously unbalanced, with relatively too many colleges and too few primary schools, though this is now being rapidly remedied. Japan on the other hand introduced universal primary schooling as long ago in 1890, when it was still a very poor country, leaving large expenditure on colleges until later. This played a very important part in Japanese economic growth. The recent acceleration of economic growth in Britain is also probably the consequence of larger expenditure on education after 1945. Expenditure on education requires more than a decade to bear fruit and therefore does not appeal to the politician looking for quick results.

IV

THE ROLE OF AGRICULTURE IN ECONOMIC GROWTH

At the risk of saying the obvious, we may begin by pointing out that the purpose of agriculture is to produce food, and certain raw materials for industry. A large increase in the agricultural output of India is essential for three separate reasons. These are (1) to provide more to eat for all those who are at present underfed, (2) to maintain an increased proportion of the labour force in industry, (3) to provide needed export income—a requirement which is often forgotten.

In judging the adequacy of Indian food supply we should not use the caloric standards laid down by F.A.O. If these are correct, the population of Japan is living on the edge of hunger though the majority of Japanese families own television sets!—and the population of China died out some years ago. It is erroneous to lay down a single caloric standard for the whole world. Needs vary according to climate, average body weight, the proportion of their time in which people are occupied in heavy labour, and the proportion of children in the population. Taking all these factors into account, caloric requirement per person per day in India averages only about 1,600. Indian food supplies, averaged per person, exceed this figure. However, what information we have shows that in both urban and rural communities they are unequally distributed. Many of the families of the rural landless labourers and lower castes are probably below the hunger line. There is probably also an unequal distribution of food within the family itself.

Calories provide the energy for bodily activity but proteins are needed to perform the "maintenance work" of the body. In the case of a community living predominantly on grains, if the caloric supplies are adequate, then the protein supply from the grains will probably be adequate for adults, but not for children; and there is some doubt about the quality of the protein obtained from maize, possibly also of rice protein. Small quantities of protein from milk or other animal sources are also medically necessary. A medical survey has shown that 17% of the children in Maharashtra show clear indications of protein deficiency; and the situation may be worse in other states. The best sources of additional protein are pulses, ground nuts and milk, whose output should be increased as quickly as possible.

The proportion of the Indian labour force industrially occupied (using the word "industrial" to indicate all non-agricultural activities) at the last Census was only 30%. This was almost exactly same as it had been at the time of the first available Census information in 1881. It is true that most of the "industrial" workers of that time were handicraftsmen of low productivity; nevertheless, India is about the only developing country in the world in which the proportion has remained unchanged for so long. The reason for this is simply the low productivity of Indian agriculture. If India is to maintain an increased proportion of the labour force in industry, farmers will have to produce a substantially increased saleable surplus in order to feed them. This task is made all the more difficult by the fact that urban workers consume more food (for reasons which sociologists will have to analyse) than farmers at the safe level of real income, and also increase their food consumption more rapidly than farmers when their incomes rise.

Import requirements are something which planners tend to forget. It is true now that India is providing herself with textiles, steel and other products which she used to import. But during the process new and urgent import needs arise for equipment, materials, spare parts, etc. We know that all demands for import permits are thoroughly, indeed excessively, checked by the Exchange Control Authorities. Even so, imports amount to 7% of national product. Experience from all countries shows that each further rise of 5% in national product is likely to lead to a rise of at least 3½% in import requirements. This means that the amount of imports required will go on increasing, though its ratio to national product will gradually decline. It is only because India already has a large national product (because of its large population) that the ratio of imports to national products is as low as it is; only U.S.A., and U.S.S.R. and China have lower proportions. In many small countries the ratio of imports to national product is 40—50%.

At present, Indian exports only suffice to pay for less than 60% of imports. The balance has to be paid for by foreign aid. This state of affairs cannot continue permanently. In any case, import requirements are going to increase. Recently "non-traditional" exports including steel, petroleum products, pharmaceuticals, bicycles, etc. have made a most encouraging advance, at the rate of 20-30% per year. This has been brought about partly by devaluation, but also by the unpleasant medicine of recession and underutilised industrial capacity which has compelled Indian industrialists to go out and seek export markets. In 20 years or so such commodities may pay for the larger part of India's import requirements. But their present export total is very small. In the near future India's urgent import needs can be met only by a large increase in agricultural production, firstly to replace the grains now imported, but in addition to produce large quantities of additional produce for export. In world markets the prospects for grains and sugar are not good, for cotton moderate, reasonably good for oil seeds, tobacco and other specialised crops.

It has been pointed out above that the imposition of a heavy land tax, assessed on the productive capacity of the land, but not increasing when farmers increased output, would do more than anything else to increase agricultural production.

Subject to the above, increased productivity in Indian agriculture can be brought about by four factors, named in order of urgency, (1) fertilisers, (2) water, (3) roads and (4) education.

The return from fertilisers is very great, and the bungling of the Government fertilisers production programme, and the long delays in granting permits for private production, have done immense harm. Measured per ton of nitrogen content, fertiliser which can be bought at works in Japan or U.S.A. for about 150 dollars (to which transport and distribution costs must be added,) will yield no less than 10 additional tons of grain, which cost 700 dollars or more to import. So even if nitrogenous fertilisers have to be imported, they still represent a large net saving of foreign exchange. So also do phosphatic fertilisers though not to quite such a high degree.

In recent years, Pakistan has made substantially more rapid progress than India, both in the use of fertilisers and in the development of water resources, with consequent improvement in agricultural output. The construction of further large dams for irrigation should be deferred for some time, in view of the very costly system of distribution canals required, the long delays in completion, and the fact that the most favourable dam sites have already been used. The best economic returns will be obtained from comparatively small tube wells with diesel or electric pumps which farmers can construct and operate themselves, selling surplus water to their neighbours. In this way water can be obtained at a cost of 2-3 Paise per cubic meter, which is sufficient to produce a quarter kilogram of wheat (or comparable quantity of other products) worth more than 25 Paise at present prices.

Tube wells are however only possible in the plains and after a number of years will lower the water table. In the hill areas some additional supplies can be obtained from small earth dams.

Many villages in India are still without all-weather roads. Experience in many countries shows how rapidly agricultural output increases and diversifies when a good road becomes available, making it possible to take produce to market quickly and cheaply.

Universal primary schooling, introduced throughout Japan, including rural areas, as early as 1890, played a very important part in creating willingness to innovate on the part of Japanese farmers and fishermen.

AN INTERVIEW WITH MAHATMA GANDHI

In June 1947, at the time India became an independent country, I was Under-Secretary of State for Labour and Industry and Economic Adviser to the Government of the State of Queensland, Australia. India did not then have a Planning Commission, but an Economic Adviser and staff. This post was occupied by Professor Parekunnel Thomas, of the University of Madras, an old friend of mine. At his suggestion the Government of India requested the Queensland Government to release me for a few weeks to assist him in the work which he was then doing, particularly in reviewing the available information about investment, savings, and capital stock.

Professor Thomas had been an early supporter of Gandhi, and had maintained contacts with him, and so was able to arrange an interview for himself and for me, one day in late November 1947. Gandhi was sitting cross-legged on his string-bed in front of his little hut on the lawn of Mr. G. D. Birla's residence in New Delhi. Gandhi knew that economics was my profession.

The conversation opened in a most unexpected manner. Gandhi asked, "Do you know what is the matter with the Indian people, Mr. Clark?" "No, Mahatma," I replied. "They're idle. They won't work," he said.

This was rather strong, and I thought that perhaps I should plead for the Indian people against their Leader. "But I understand," I said, "that the Indian people are more interested in spiritual than in material things." "Don't you believe it," Gandhi replied firmly. "You may see a man sitting under a tree who says that he is engaged in religious meditation. But all that he is really doing is avoiding work."

Gandhi went on, "I have told you what I think about the Indian worker. I have a very bad opinion also of the Indian businessman. He is mainly interested in speculation". I asked Gandhi if he was looking forward to the transformation of India from an agricultural into an industrial country. "Yes," he replied. "I work my own spinning-wheel"—he pointed to another small hut where he kept it—"everyday as a religious exercise. But that does not mean that I disapprove of modern machines. The condition which I would make however is that industry should be distributed throughout the country and not concentrated in large industrial cities, which I regard as evil. A few such cities may be unavoidable evils, but we should do our best to decentralise industry. There are two reasons for this. Firstly, all that is good in Indian culture is based on rural life, and we should do our best to preserve this culture. Secondly, while I see no harm in the village trading with the town in order to purchase some of the amenities of life, I regard it as intolerable that the village should depend on a distant town for any of the necessaries of life. Clothing, for example, it should make for itself."

At this time, in 1947, rationing, price control and compulsory acquisition of grains from the farmers were coming into force. Gandhi was implacably opposed to all of them. "I have tried to explain this to Nehru," he said, in tones at once patronising and regretful, for Nehru had been his disciple, "but he cannot see it. The principal consequence will be that the farmer will produce less and consume more, including feeding more of his grain to his animals. The right thing to do is to let the price of food go up. Then everyone will work harder."

At this time, there was not much talk about contraceptives and sterilisation. In a few words, Gandhi expressed his categorical condemnation of them.

Reflectively and at length, Gandhi began to recount some reminiscences of his time as a young barrister in South Africa which he seemed to regard as the happiest time in his life. Gandhi chuckled when he recollected that in Durban he had worne a frock coat and silk hat, the recognised dress for professional men in those days. "I have a great love of living things", he said, and at his home in Durban, where the rainfall is more generous than in Delhi, he had planted a large garden of pineapples, and also persuaded his friends and visitors also each to set a few plants, by which he could remember them.

I asked him about a statement by Mr. Pakwasa, a State Governor, which was published by "The Statesman" (25th November, 1947) under the heading "India First, Religion Afterwards". "The Governor said that religion should be one's private affair and one's nationality should come first and religion after, as was the case in other countries where people were known by their nationality and not by their religion. Every Indian, he said, should think in terms of India, considering himself an Indian first and last."

Gandhi asked me if I would like to have an autographed reply on this question, and gave me the following:

"Religion is not subservient to nationality. Each is equal to the other on its own platform. Each has to be defended against the whole world."

8

Some Economic Aspects and Problems of Under-Developed Countries

By
Prof. P. T. Bauer

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INTRODUCTION

The economic development of under-developed countries has rightly been stressed as the major problem of the twentieth century. Among the leading economists of the world who have exercised their minds on this important problem is Prof. P. T. Bauer, Smuts Reader in Commonwealth Studies and the Fellow of Gonville and Caius College of the University of Cambridge. He is author of two well known books on the Subject: "Economic Analysis and Policy in Under-developed Countries" and "The Economics of Under-developed Countries" (co-authored with Prof. B. S. Yamey).

When Prof. Bauer visited India recently, the Forum of Free Enterprise was glad to have the opportunity of presenting him to the Indian public. His two lectures on "Economic Progress of Under-developed Countries" delivered in Bombay on September 8 and 9 were greatly appreciated for their authoritative nature and thought-provoking contents. Prof. Bauer's approach is fresh and invigorating as the following pages would convince the reader. We are, therefore, glad to print the text of the lectures in the form of this booklet.

Let me, on behalf of the Forum of Free Enterprise, take this opportunity to express our sincere and heartfelt thanks to Prof. Bauer for delivering the lectures and for taking the trouble of editing the transcript, and giving us the permission to reproduce it.

A. D. Shroff
President, Forum of Free Enterprise.

Bombay,
December 17, 1958.

In these two lectures I shall deal with some economic aspects of under-developed countries, some influential ideas on under-developed economies, and also with some issues of development policy. I want to consider especially some pervasive ideas which underlie current discussion on policy, and which also profoundly affect Indian economic planning.

In the course of the last ten or fifteen years, there has been a vast increase of interest in economic development, especially of under-developed countries. Their economic position and prospects have become principal issues in international politics. For instance, Mr. Hammarskjoeld, the Secretary-General of the United Nations, said in an official address in Geneva in July 1955 that their economic development was "the major long-term economic problem (of the present generation), the greatest economic challenge to all nations, both individually and collectively...the United Nations' chief task."

Economic development is as old as humanity, and speculation about it goes back to the classical economists of the 18th and 19th centuries, and beyond them to the Middle Ages and, indeed, to antiquity. But the ideas which now dominate the discussion are very different from previous notions; and it is these new ideas which set the intellectual framework of contemporary discussion of policy in this vitally important sphere. They are reflected in such influential writings as in the books of Dr. Gunnar Myrdal, who is now in India, notably his widely read book *An International Economy* and Professor Ragnar Nurkse's book *Problems of Capital Formation in Under-developed Countries,* and they set the tenor of the vast United Nations literature on the subject, including the publication of ECAFE and the well-known U.N. Report on Measures for the Economic Development of Under-developed Countries, of which Professor Gadgil was a signatory, and they also dominate the most influential Indian thinking in the sphere as is clear from the literature of the Planning Commission, the writing of influential Indian economists and the pronouncement of cabinet ministers.

Let me begin by summarising the principal arguments of this dominant set of ideas. Its corner-stone and leading theme is the alleged presence of a vicious circle of poverty and underdevelopment. This thesis is presented in several distinct and different variants, which, however, are not exclusive but cumulative. The most frequent suggestion is that the low level of income renders saving impossible, thus preventing the capital accumulation necessary for an increase in income. Others include the suggestion that the narrow markets of low-income countries obstruct the emergence and extension of the specialisation necessary for higher incomes; that demand is too small to permit profitable and productive investment; that government revenues are insufficient for the establishment of effective public services; that malnutrition and poor health keep productivity low, which prevents a rise in income; and there are others as well. The stagnation of the under-developed world is said to reflect the failure of the traditional forces of economic progress, such as development of production for the market and of international exchange and private investment. The vicious circle can be broken only by drastic national and international action.

Here are a few typical formulations of the thesis of the vicious circle. Professor Paul A. Samuelson writes in *Economica,* probably the most widely used economic text in the Western world:

> "They (the backward nations) cannot get their heads above water because their production is so low that they can spare nothing for capital formation by which their standard of living could be raised."

Here is another formulation, this time from a study prepared for an official United States committee by the Centre for International Studies of the Massachusetts Institute of Technology:

> "The general scarcity relative to population of nearly all resources creates a self-perpetuating vicious circle of poverty. Additional capital is necessary to increase output, but poverty itself makes it impossible to carry out the required saving and investment by a voluntary reduction in consumption."

As the developing countries are progressing substantially, there is, according to these ideas an ever-widening gap in income, capital, standard of living and rates of growth between the developed and underdeveloped world. Dr. Myrdal writes in *An International Economy*:

> "It is the richer countries that are advancing while the poorer ones with the large populations are stagnating. For mankind as a whole there has actually been no progress at all... As Mr. H. W. Singer has rightly pointed out, world real income per capita, and with it the standard of living of the *average* human being, is probably lower now than twenty-five years ago, and perhaps lower than in 1900, because the nations that have rapidly raised their economic standards have been a shrinking proportion of the total world population."

This last statement, which also reflects very influential and widely held views, is both unsubstantiated and also meaningless.

There are no series of national income figures for any Asian or African countries before the First World War and only a few most speculative estimates for individual years or periods for the interwar years. Even if the statistics were available, it would be difficult to use them as a basis for meaningful comparisons because of fundamental changes in the conditions of living in many underdeveloped countries over the last half century. This conclusion is reinforced by another consideration of a slightly more technical nature. Those of you who have studied elementary statistics will realise that the passage I have quoted reflects a misuse of the concept of the average. The median income could fall even if individual incomes rise everywhere if population increases much faster in poor countries than in richer countries. This is because an average can fall even if all the component element increase, if there is a change in the relative importance of these component elements, i.e., a change in weights. It is clearly meaningless to say that there has been no economic progress in these conditions.

To return to the main argument of the dominant set of ideas. The adverse effects on private saving and investment of the low level of income are said to be reinforced by certain economic shortcomings of the population, such as a general inability to take a long view, an unwillingness of the few rich people to save and invest, and a dearth of constructive entrepreneurship, reflected in a greed for quick returns, and a lack of innovating ability. According to these ideas international private investment cannot alleviate the situation, since one aspect of the vicious circle is a lack of profitable private investment opportunities.

Large-scale compulsory saving and comprehensive development planning are deemed necessary to break the vicious circle. The need for development planning is regarded as self-evident. One aspect of such policies is large-scale state support or ownership of manufacturing industry, the development of which is regarded as a condition of economic advance.

The national measures must be supplemented by large-scale inter-governmental grants or subsidised loans because underdeveloped countries are too poor to raise sufficient capital to break the vicious circle. Failure to achieve this would imply continued stagnation or even retrogression of the under-developed world and an ever-widening gap in living standards, with the probability of political catastrophe on a world scale.

Most of these ideas are demonstrably wrong.

These ideas first assume or state explicitly that the poverty of underdeveloped countries establishes a basic similarity in the conditions of their economic advance. The underdeveloped world so treated in most of these discussions includes virtually the whole of Asia (except Japan), all of Africa, almost the whole of Latin America (with the occasional exception of the Argentine and Uruguay), the Caribbean area, and the most of Southern Europe; about two thousand million people, over-two-thirds of the world's population, inhabit these areas.

When considering the economic position, the development prospects, and the possible methods of economic advance of underdeveloped countries or their capital requirements, it must always be remembered that the greater part of the world is being discussed, and that this is not a stagnant homogeneous mass, but a vast aggregate of great diversity in such matters as population density and growth, political and social institutions, rates of progress, the economic qualities of the population, and many other respects. It includes areas which have largely stagnated in recent decades, such as parts of Central America and of the Caribbean, or Liberia or Ethiopia, or parts of India and Pakistan, and also countries which have advanced very rapidly, such as Columbia, Venezuela, Ghana, Nigeria, Malaya and Hong Kong; very densely populated regions such as Java, much of India and Pakistan, and sparsely populated areas such as Sumatra, Borneo, most of Africa, and Latin America; traditional and highly stratified societies such as those of India and Pakistan, the Moslem Middle East, most of Africa, and the much more fluid societies of South-East Asia, West Africa and Latin America; the semideserts of the Middle East and East Africa, and the tropical jungles of Africa, Asia and Latin America; the thriving modern cities of South-East Asia, the tens of thousands of custom-ruled villages of the Indian peninsula, and the tribal communities of Africa. Underdeveloped economies do indeed exhibit certain common features which justifies limited generalisations for certain purposes. For instance, the comparative importance of subsistence production in most underdeveloped countries is one such general aspect. However, for many other purposes, especially in the framing of policy, it is essential to remember their deep-seated diversity.

The leading theme of the dominant set of ideas, the vicious circle of poverty and stagnation, is manifestly invalid. Most obviously it is refuted by the very existence of developed countries, for the simple reason that all these began as under-developed. If the rigid formulation of the thesis of the vicious circle of poverty were valid, no country could ever have developed. The countries which are now developed all began as under-developed countries, and they advanced usually without appreciable external capital, and almost invariably without grants from abroad. Of course, more generally the thesis of the vicious circle is refuted by the rise to prosperity of many poor individuals and groups throughout the world, including the prosperity and massive capital formation by originally penniless immigrants in many parts of the world, including the underdeveloped world. Examples of such capital formation include that of the penniless Chinese immigrants in Malaya, very poor Indians in East Africa, Jews in

South Africa, Lebanese in West Africa, the West Indies and Brazil, not to speak of the vast capital accumulation in the United States and Canada by very poor immigrant communities.

The rapid economic advance of many underdeveloped countries in recent decade, which again refutes the allegation of a generally operative vicious circle of poverty and stagnation, is of special interest and relevance because it shows that forces which have made for economic advance in the earlier history of developed countries still operate in many parts of the underdeveloped world. Here is some evidence on this subject.

According to the statistics of the Economic Commission for Latin America over the period 1935 to 1953 the gross national product in Latin American Countries increased at an annual rate of 4.2 per cent, and output per head by 2 per cent. Over the period 1945 to 1955 the rate of growth was even faster, as output per head increased by 2.4 per cent annually (appreciably higher than in the United States), and total output by about 4.7 per cent.

South-East Asia and West Africa are other parts of the under-developed world which have developed very rapidly in recent decades. For these regions there are no series of national income figures going back before the second World War. At present the national income of Malaya is about £100 per head per annum, and that of Ghana (formerly the Gold Coast) about £60. These are very low levels compared to Western countries, but they reflect substantial advances over the last half-century or so, because around 1900 these were still essentially subsistence economies. There is much further information on the rapid advance of these regions. Statistics of foreign trade are of particular interest in West Africa, because imports are very largely for the use of Africans, and all agricultural exports are produced by them as there are practically no European-owned plantations in British West Africa.

Around 1900, total annual imports and exports of Nigeria were each about £2 million, while by now they are each about £140 million; for Ghana the corresponding annual figures are about £1 million and £90 million. Over this period, there has been a spectacular increase in imports of both consumer and capital goods into these territories. In 1900 there were no imports, or only negligible imports, into these territories of flour, sugar, cigarettes, cement, petroleum products or iron and steel. Today these are on a massive scale. Exports of cocoa, groundnuts or cotton from Nigeria or Ghana were negligible in 1900, while exports of oil-palm produce from Nigeria were about one-tenth of their present volume. Today these are staple exports of world commerce, and annual shipments are hundreds of thousands of tons.

There is much other evidence of the rapid economic advance in these territories in statistics of government revenue, literacy, health, railway returns, and the like.

The economic development of Malaya over the last sixty years or so has been even more rapid. Domestic exports from Malaya in 1900 were about £7-£8 million annually; by now they are about £250 million. At the turn of the century there were no exports of plantation rubber from Malaya; at present they are about 600,000 tons a year, over three-fifths produced on Asian-owned properties. There has also been a very rapid increase in the entrepot trade of the country, which reflects largely the spread of the money economy throughout South-East Asia. Thus, while in 1900 total Malayan exports and imports together (including re-exports) were around £50 million, at present the figure is about £900 million.

For all these territories statistics of public revenue, infant mortality, literacy, and railway transport all confirm the picture of rapid economic development. To give but one example, in Singapore the infant mortality rate fell from about 230 per thousand births in 1920-21 to about 50 per thousand births at present.

While I think Latin America, South-East Asia and West Africa are among underdeveloped regions which have advanced most rapidly in recent decades, there has been substantial progress throughout the underdeveloped world. Even in India, where economic progress in recent decades has been slower than in many other underdeveloped countries, there is evidence of economic progress over the last half century from such information as the volume of industrial production, the increase in the literacy rate, the reduction of famine and disease, the fall in the infant mortality rate, the increased consumption of fresh fruit and vegetables, and the substitution of higher for lower quality food grains. These advances, especially the reduction in mortality, the decrease in epidemic diseases and the reduction to famine, are obvious from the simplest facts of Indian economic history.

The changes brought about by the economic advances in many underdeveloped regions, especially in South-East Asia and West Africa, but not only there, have been so far-reaching that conventional statistics such as those which I have already quoted cannot convey their full effect. In 1890's Malaya was a sparsely populated country of hamlets and fishing villages, where tribal welfare and communal raids were recurrent, and malaria was endemic. By the 1930's tribal warfare and communal disorder had disappeared, malaria was very largely suppressed, and the population had increased greatly, both through immigration and natural increase, and there had emerged a number of thriving and populous cities, linked by excellent communications. In West Africa around 1900 there was still tribal warfare, slavery, slave raiding and in places even cannibalism. Over large areas people had not yet invented the wheel or even seen one, nor had they evolved forms of administration beyond the village and the clan. In the same area today there are large administrative and trading centres with populations of over 100,000; and there are Africans owning large transport enterprises with fleets of thirty lorries or more. Such profound changes much affect the meaning of discussions whether differences in income per head between underdeveloped and developed countries have increased or diminished over the last half-century. I may say, I am convinced that they have been reduced, but that is another matter. The changes have been so far-reaching that the concept of income in the conventional sense is not helpful in expressing them.

The inadequacy of the conventional national income estimates for conveying such far-reaching changes is reinforced by certain implications of the increase in population which has accompanied economic growth throughout the underdeveloped world. The population has increased greatly throughout the underdeveloped world over the last half century. Since 1900 the combined population of India and Pakistan, i.e., undivided India excluding Burma, increased from about 280 million to about 480 million; and over this period the crude death rate declined by almost two-thirds, from about 38 per thousand to about 14 per thousand. The population of Ceylon increased over this period from about 3½ to about 8½ million, and that of Ghana from about 1.5-1.8 million to about 4½ million. These increases in population do not negate the reality of economic advance, but are rather evidence of it, since they reflect a fall in death rates resulting from the elimination of famine and of epidemic and endemic diseases, and from the suppression of tribal warfare and other forms of communal disorder. These advances, notably the benefits of a lower death rate and of the larger life expectation, are ignored in discussions which are conducted solely in terms of *per capita* figures. Yet the position of those who have failed to die has certainly improved; and so has the position of those whose children continue to live. It is a fact that people like going on living and they are prepared to pay for the satisfaction of the postponement of their own or the death of their children. Reliance solely on *per capita* income figures implies a criterion of economic advance which registers the birth of a calf or the survival of a cow as signs of economic progress, but the birth of a child or the survival of a person as signs of economic retrogression. The position is essentially that there has been an increase in total output, some of which has been taken out in the form of larger numbers. However, besides the increase in total output there was in almost all these areas also a substantial increase in production and consumption per head as is clear from statistics of agricultural output, from exports, from industrial production, from foreign trade figures, from revenue returns, and from other easily accessible information.

Thus the simplest facts both of economic history and of the present position of the underdeveloped world overwhelmingly refute the thesis of the vicious circle of poverty and stagnation which is the keystone of the current orthodoxy. The level of incomes in underdeveloped countries is by definition low, but this is compatible with even rapid advance if that advance has begun only comparatively recently and has started from a very low level. This is the position in many underdeveloped countries. The thesis of the vicious circle of poverty identifies a low level of income with stagnation. This is a confusion between a low level of economic attainment and a zero rate of change. This is a simple error in logic; and as we have seen the conclusion is also refuted by easily observable empirical evidence both of economic history and of contemporary scene.

Some exponents of the dominant ideas recognise, though somewhat reluctantly, the presence of advanced and advancing (often rapidly advancing) countries, regions and sectors in the under-developed world. These advancing sectors are referred to in their writings as enclaves carved out of the local economy by the advanced countries which do not serve to improve the economic position or prospects of the local population, nor can they serve as basis for further economic progress. This is misleading. First, in many instances the progressive sectors are largely or entirely owned and operated by members of the local population. For instance, all West African agricultural exports, including such world staples as cocoa, groundnuts and oilpalm products, are produced entirely by Africans on their own lands, and the same applies to the bulk of South-East Asian and South American exports, including rubber, often classified as a European plantation crop; in fact over three-fifths is derived from Asian-owned properties. In all these areas the local population also has a large share in the transport, distribution and simple processing of these exports, and in the distribution of imports. This also applies to industrial activity in many underdeveloped countries, whether for local use or for export. For instance, there are appreciable exports of manufactures from India, Hong Kong and Puerto Rico, very largely the products of enterprises owned and operated by the local population. But even when the enterprises in the advanced sector are foreign, they usually still assist development by contributing to government revenues, by spreading skills, and generally by promoting the exchange economy.

These are not enclaves cut off from the rest of the economy, but focal points, the points of first impact, of development which always affects certain activities and regions first, from which it subsequently spreads to the rest of the economy. The time this requires depends, among other factors, on the qualities of the population, on institutional factors and on physical communications. There is nothing unusual or abnormal in the uneven regional or sectoral incidence of economic progress.

Reference to the advancing regions and sectors (at times even to entire countries) as enclaves has now become general in the literature on under-developed countries. The appeal of this catch-phrase stems in part from the spurious reconciliation it offers between the manifest evidence of progress in many underdeveloped countries, and the thesis of the vicious circle of poverty, which is both the corner-stone of the current literature on development and the basis of drastic proposals for policy.

I should like to make a point here in order to prevent misunderstanding, and to forestall a possible objection. The argument that the vicious circle of poverty is an untenable thesis should not be mistaken for a plea for *laissez fair* or any other particular policy. For instance, rapid but uneven advance can also pose very great problems and can set difficult, complex and delicate task of Government policy. But these problems are quite different from those of stagnation and would call for very different types of official actions. The development which has taken place throughout the underdeveloped world is amply sufficient to dispose of the suggestion that these countries stagnate or are otherwise caught in a vicious circle of poverty. Nor would I like my remarks to be interpreted as evidence of complacency, as suggestions that all is for the best in the underdeveloped world. I am extremely conscious of the great material poverty of large parts if not most of the underdeveloped world and of the urgent need to relieve it. But fundamentally defective ideas are unlikely to serve as a suitable basis for sane and effective economic policy.

Before leaving the vicious circle of poverty, I would like to examine briefly a particular variant of this thesis which has lately become very influential in India where it may have been partly responsible for the ready acceptance of the proposal for an expenditure tax. This is the so-called international demonstration effect, which has been advanced by Prof. Nurkse who suggests in his book on *Problems of Capital Formation in Underdeveloped Countries* that contact with advanced economies is often harmful to underdeveloped countries, because it discourages saving and prevents investment. To quote Prof. Nurkse:

> "Knowledge of or contact with new consumption patterns open one's eyes to previously unrecognised possibilities.... In the poorer countries such goods are often imported goods, not produced at home; but that is not the only trouble. The basic trouble is that the presence or the mere knowledge of new goods and new methods of consumption tends to raise the general propensity to consume.... The vicious circle that keeps down the domestic supply of capital in low-income areas is bad enough by itself. My point is that it tends to be made even worse by the stresses that arise from relative as distinct from absolute poverty. How much worse is a question that cannot be precisely determined; it is a matter of judgment and one that presumably varies from country to country."

This hypothesis suggests that international contacts may serve as a further obstacle to capital formation and economic development, thus, in a sense, substituting another vicious circle of poverty and stagnation if somehow the first vicious circle has been broken. Prof. Nurkse's formulation is, however, cautious and he notes that the operation of this effect and its applicability to different countries are matters of judgment. However, it is the unqualified version of this hypothesis which has come to be most widely quoted. The international demonstration effect has come to be regarded as a major element in the vicious circle of poverty as well as a ground for blaming richer countries for the poverty of the under-developed world and thus as justification of insisting on income and capital transfers from richer to poorer countries. The international demonstration effect is also invoked in support of far-reaching measures of policy, notably measures designed to restrict or sever international economic contacts, or special taxation of imported consumer goods.

In fact, the results of international contacts are generally precisely the opposite of those assumed by the international demonstration effect. Such contacts generally accelerate economic development in the less developed countries and regions by suggesting new wants, new crops and improved methods generally. This is well-known from economic history. At present, throughout the underdeveloped world, the more advanced sectors and areas are those in contact with the more developed countries and the most backward are those which have no such contacts. This is clear in India as well: witness the comparison of Bombay or Calcutta's industrial regions with the outlying areas of Uttar Pradesh or Kashmir and similar regions.

It is worth examining the international demonstration effect more closely. In effect it omits to note that the new types of consumer goods brought to the notice of the population can be bought only if incomes are first earned to buy them; and that the desire for a higher and more varied consumption can stimulate saving and investment to satisfy the new wants. Indeed, until quite recently the absence of new wants and the inelasticity of consumption and the rigidity of established habits used to be regarded as major obstacles to economic development. Investment is very generally necessary to make possible production for sale, and this invariably so if subsistence cultivation is replaced by production for exchange. In these circumstances, the demonstration effect induces a higher economic performance; this performance is reinforced when the contacts also acquaint the population with new crops and methods of production, the adoption of which makes possible the satisfaction of new wants. You can observe this in many parts of the underdeveloped world. In East Africa, Indian traders bring bicycles, textiles and hardware to the notice of the African population which has never thought of these articles. In order to purchase these goods the Africans then produce cotton and coffee for sale. This process has been a major factor in the spread of the exchange economy in Uganda. In West Africa the Lebanese have played a similar role. In South-East Asia the activities of the Chinese in bringing hardware, textiles and other articles to the notice of the population in up-country Malaya, Thailand, Sumatra and Borneo has been a major factor in the spread of rubber production and in the agricultural capital formation associated with it. Moreover, by generating cash incomes this process promotes investment also in other parts of the economy besides the sectors first affected by them. Public investment made possible by increased government revenues is a familiar example. The usual exposition of the international demonstration effect seems to assume that the exchange economy has already permeated the entire economy, or at any rate that the expansion of the exchange sector is unaffected by consumption prospects, and more generally by the attractiveness of that sector. These are the assumptions manifestly inapplicable to most underdeveloped countries including India, over a large part of which subsistence cultivation is still predominant and where development of production for sale is a major requisite of economic development.

The recognition of the importance of the expansion of the exchange economy as a factor in economic development, and of the attractiveness of that sector as a factor influencing its expansion, has important implications for policy. For example, if import restrictions greatly curtail the supply of consumer goods which serve as incentive goods which induce people to produce for exchange, their imposition may discourage the development of production for sale, including the production of export commodities or import substitutes (including food). Thus such measures may worsen and not improve the balance of payments, besides retarding economic development. These effects are implicitly recognised in the traditional terminology which refers to these consumer goods as inducement or incentive goods. Yet these aspects and implications of import restrictions and of consumption taxes seem to be almost wholly ignored in public discussion in India.

There is one sphere of economic life where the international demonstration effect does indeed seem to apply and to result in economic waste. Governments, politicians, and government officials seem to be affected by it, in that they often propose and adopt technical and social standards which are inappropriate and wasteful in the circumstances of their countries. The same applies to the attraction of conspicuous and spectacular investment undertaken in an attempt to imitate technical achievements of other countries. This sort of conspicuous expenditure is not limited neither to public authorities nor to under-developed countries. But it has been prominent in government spending in many under-developed countries including, I believe, India. Apart, however, from this important exception, the international demonstration effect is hardly a significant factor obstructing capital formation in under-developed countries. Indeed, as I have already suggested, in the private sector it is much more likely to promote rather than to retard capital formation.

In the economic advance which has taken place in many under-developed countries, agricultural production for sale, that is the production of cash crops, has played an important part. The same applies to the economic history of more highly developed countries. Production of cash crops is generally accompanied by the establishment, extension, and improvement of agricultural properties, that is by fixed capital formation in agriculture. This important aspect of the economic landscape has been much neglected in contemporary literature, in which significant categories of capital and capital formation are often ignored. Cultivated agricultural properties and their extension and improvement are the most important of these neglected categories; others are live-stock, various types of equipment, simple structures, and, in a related field, traders stocks.

In underdeveloped countries, agriculture and its ancillary activities are a large proportion of economic activity. Whether they are used for the production of subsistence crops or cash crops, cultivated agricultural properties are income-yielding assets, the productivity of which exceeds that of unimproved land as a result of the expenditure of human effort and activity; and the process of establishing, extending, and improving the land is investment. To disregard it amounts to neglecting all direct agricultural investment in the non-monetary sector of the economy, as well as much of it in the monetary sector (when the land is used for the production of cash crops). These incomplete estimates of investment, that is, estimates which referred only to part of total investment, are often related to the total population or to the total national income which is misleading. These neglected categories are also qualitatively important in the sense that they play an important part in the development from subsistence production to a market economy.

The neglect of these types of investment especially of fixed capital formation in agriculture often results in anomalies. Thus the expenditure of over £35 million on the East African groundnut scheme is treated as investment and included in the gross investment of the sterling area, even though it has not yielded any groundnuts. At the same time the establishment and improvement of hundreds of thousands of agricultural properties in both West and East Africa, which produce millions of tons of groundnuts, is generally ignored in discussions and estimates of capital formation. Thus an expenditure which has not produced any groundnuts is regarded as part of gross capital formation, but the establishment of holdings which yield a huge tonnage of groundnuts is not so treated.

The presence and significance of investment of agriculture are relevant to a wide range of issues in development policy. They again refute the suggestion of a vicious circle of poverty for they represent substantial capital formation brought about with comparatively small money expenditure. These types of capital and capital formation are also relevant to the rational framing of taxation and of public expenditure, because these cannot be arranged rationally unless the repercussions both of the collection and of the expenditure of funds on these types of capital formation are firmly borne in mind.

Recognition of the presence of fixed capital formation in agriculture also refutes the belief in the allegedly inherent economic short-sightedness of the indigenous populations of underdeveloped countries. This is an important practical point. Much of this investment is in the establishment of small properties of tree or bush crops such as rubber, cocoa, tea and coffee, which are not indigenous in the most important producing regions into which they were introduced comparatively recently. These are products of trees or bushes which do not bear until they are about four to six years old. There are certainly well over five million acres under rubber smallholdings in South-East Asia, while the area under cocoa in Nigeria and Ghana alone exceeds two million acres. Rubber and cocoa trees do not come into bearing until five or more years after planting. Therefore, every Malay or African who plants such trees is capable of looking forward at least five years. This simple evidence conclusively refutes the widespread opinion, which often serves as justification for drastic policies, that the populations of these territories are incapable of taking a long view in economic affairs. It is quite true that the African or Asian population does not readily undertake industrial or large-scale transport or trading enterprises for the simple reason that such activities are not suitable to their circumstances. But it is abundantly clear from the readiness with which the Africans and Asians plant tree crops that they can take a long view in economic affairs.

The substantial investment in agriculture and the recent progress in many underdeveloped countries and the earlier history of the developed nations also bear on the question of the role of social overhead capital, or infra-structure as it is sometimes called in economic development. This infra-structure consists of such installations as ports, railways, roads, which do not produce commodities directly but promote economic activity generally. The absence of this infra-structure in underdeveloped countries is supposed to present a particularly intractable obstacle to economic progress because without these installations economic advance is said to be impossible, while the high cost puts them beyond the means of poor countries, and at the same time the economic return is either too long delayed or too general or indiscriminate for private financing. However, the governments of the under-developed countries could borrow from private sources and service the loans from increased revenues, which is indeed what has happened in many underdeveloped countries in the comparatively recent past. In other instances there were certain natural facilities such as good harbours or navigable rivers, and the other facilities developed simultaneously with the expansion of economic activity and out of the revenues yielded by it. This, for example, has been the process in Malaya, where at the beginning of the century there were hardly any roads and only modest port facilities, while today there are thousands of miles of metalled roads and up-to-date post facilities.

The infra-structure of reasonably highly developed economies represents massive amounts of capital, and its construction absorbed a large part of total investment over decades or even centuries. Proposals for foreign aid often suggest that this aid is required "only" for the erection of the necessary infra-structure (which in these discussions sometimes includes even certain types of manufacturing industry, especially the production of capital goods), and that its provision will create conditions for development based on private investment from external and internal sources. In fact the construction of infra-structure of a developed economy is very expensive; but, fortunately, it is not a precondition of economic advance. The suggestion that a ready-made infra-structure is necessary for development ignores that this is usually developed in the course of economic advance; it is an example of an unhistorical and unrealistic attitude to the process of economic development. These discussions imply that God has somehow created developed countries with a ready-made infra-structure, while the under-developed countries have not been thus provided. Nowadays the problem of financing the infra-structure has been made more difficult by various factors, such as the poor record of many under-developed countries in the treatment of foreign capital, or a diversion of resources into subsidised manufactures or various spectacular investment schemes which reduces the funds available for the construction and maintenance of the social overhead. But these factors are rarely mentioned in current discussion.

I now turn to another topic which plays an important part in public discussion and policy in India. This is the role of manufacturing industry as an instrument of economic advance and the role of the government in promoting manufacturing industry.

In many contemporary discussions, especially in India and Latin America, Government sponsored industrialisation is widely regarded as the key to economic development and to the improvement of standards of living. Unfortunately, once again, much of the discussion is confused by an irrational attitude by which manufacturing industry is regarded as the cure-all for stagnation and poverty. In fact, manufacturing industry is simply one type of economic activity, and there is no inherent reason why this activity rather than some other activity should at any given time promote either the most efficient allocation of resources or their most rapid growth.

There are many highly developed areas of the world which are primarily agricultural in North America, Western Europe and Australia; and most regions which are now industrialised had reached high levels of development at earlier stages of their history when they were still largely agricultural.

I cannot here discuss all the arguments advanced in support of accelerated industrialisation. But I want to refer to a few of the most popular themes, especially those which are prominent in Indian discussion.

It is often said that the greater relative importance of manufacturing industry in the developed compared to the under-developed countries is evidence that manufacturing industry is a key instrument of economic development. Moreover, within under-developed countries income per head in the manufacturing sector is usually higher than in the agricultural sector, and this is also advanced in support of the proposition that industrialisation promotes the development of higher incomes.

But this is misleading. It cannot be inferred from the higher level of real income in the more industrialised countries or sectors that their advantage stem from industrialisation. It is quite possible, and is often obviously the case, that the higher level of real income and the higher degree of industrialisation are both results of the same set of causes or influences, such as the possession of, or access to, cheap sources of power, rich mineral ores or some other natural resource, or of accumulated capital, skill, technical or managerial ability. In such circumstances, the extent of manufacturing activity cannot be regarded as the cause of a high level of real income. In these circumstances both the high level of real income and the level of manufacturing activity are both effects of some other cause, viz., the access to, or possession of valuable resources. This is an example of an important general consideration; a statistical association does not necessarily denote a cause and effect relationship. For instance, it is also true that in developed countries there are generally more hairdressers per thousand of population than in underdeveloped countries, but it has not yet been suggested that the best way to promote development would be to increase the number of hairdressers. Yet this would be just as logical as the advocacy of industrialisation on the basis of the statistical relationship between manufacturing industry and a high level of real income. It is absurd to judge the needs of an economy in a particular stage of development and with a particular collection of resources by reference to some of the characteristics of far wealthier, different and more advanced economies. A situation in which manufacturing is comparatively unimportant may be an inevitable stage in economic development and may represent the most efficient use of resources at that stage.

As a matter of fact, the statistical relationship between manufacturing industry and real income is not simple as is often suggested. For instance, in the United States only about a quarter of the occupied population is in manufacturing industry, a far smaller proportion than in the United Kingdom; yet real income per head in the United States is appreciably higher than in the United Kingdom. The United States, Canada, New Zealand and Sweden all have a much larger proportion of their population in agriculture than the United Kingdom, and yet their real income is much higher. In the United States it was not until towards the end of the nineteenth century that manufacturing industry became generally prominent in the economy; and not until 1970 did the size of the labour force employed in agriculture cease to increase. And it is especially noteworthy in this context that not until 1941 did manufacturing employment exceed agricultural employment in the United States, by which time it had for many decades been the richest or one of the richest countries in the world.

Another line of argument for accelerated industrialisation is based on the necessity of the growth of manufacturing industry to absorb the surplus population on the land and put it to productive work. This argument is not so crude as the one I have just discussed, and it is to some extent more acceptable. But again it is quite inconclusive. The distinction between cultivable and uncultivable land is not as clear as is often implied. Estimates of cultivable lands are largely arbitrary, and land classified as uncultivable is often cultivable even with existing techniques. Moreover, land which is classed as uncultivable in particular conditions can often be brought into cultivation with changes in technology or government policy, or with the expenditure of capital. Even in India, which is often instanced as a country in which there is no remaining land suitable for cultivation, there are extensive areas described as cultivable waste which, in the opinion of many people, would be suitable for cultivation with modest capital expenditures. Thus it is possible that the surplus rural population could be absorbed more profitably and with less expenditure of capital in the extension of agriculture than in the establishment of new industries.

Another argument in favour of accelerated industrialisation suggests that because at higher income levels an increasing proportion of income is usually spent by the people on non-agricultural products, development necessitates an increase in the proportion of people in non-agricultural activities especially in manufacturing industry. But this again is not a clear-cut idea. It is often easier for a country to procure for itself manufactured goods by specialising on agriculture for exports. This is compatible with a very high standard of living, as is clear from the experience of large parts of the United States, Canada, New Zealand, Australia, Denmark and many other countries. The possibilities of profitable and productive specialisation and exchange are as real for a country as for a region, a district or, for that matter, any other group of persons; and its opportunities are obviously present internationally as well as within a country.

This conclusion is reinforced by another important consideration which is based on somewhat technical reasoning which will, however, be readily intelligible to those of you trained in formal economics. Even within a closed system the prospective pattern of economic activity cannot be inferred from the simple proposition that the income elasticity of demand for industrial products is higher than that for the products of agriculture. When applied to the whole economy, the concept of the income elasticity of demand raises problems of aggregation which effect any general proposition about changes in its average value with economic growth and this applies particularly when relative factor prices and the distribution of incomes change. The proportion of the total national income spent on agricultural products is necessarily the average of the proportions of income spent by each member of the population as a whole. Even if the income elasticity of demand for these products of every member of the population is less than unity (which is by no means necessarily the case), so that each individual spends a smaller proportion of his income on these products as his income increases, the average proportion of income spent on these products may still increase if most of the increase in the national income accrues to people whose relative expenditure on these products is above the national average. Such a result is a likely contingency in under-developed countries where the income elasticity of demand for many of these products is still generally high. There is no ground for assuming a unique relation between changes in national income and changes in the average expenditure on agricultural products; still less between changes in the national income and the proportions of the population in agricultural and industrial occupations.

There are two further arguments for large-scale industrialisation often heard in contemporary discussion and which have been put to me by members of the audience at lectures which I gave in India and Pakistan. According to one argument, rapid and accelerated development of manufacturing industry is necessary because primary producers somehow face inherently deteriorating terms of trade; and this suggestion is sometimes supported by reference to an alleged deterioration in the terms of trade of primary producers from the 1870's to the 1930's. I find it hard to make sense of this opinion, and I want to mention only the most obvious objections. The statistics usually quoted are almost wholly emptied of significance by the fact of fundamental changes in the conditions of production over these periods, such as the shift in rubber production from that of a South American wild crop to that of an eastern plantation crop. In the 1870's the small amount of rubber exported was collected from jungle trees standing perhaps one or two trees to the acre in the dense forest. At present rubber production takes place on estates and small holdings with a hundred or more trees to the acre in easily accessible areas. This is only one example showing the meaningless nature of the statistics usually quoted, which are quite unrelated to factorial terms of trade. But even if the factorial terms of trade had deteriorated, it would not follow that this would continue in the future (in fact, of course, the movement has been quite different during the last twenty years); but even if it did, it still would not follow that other types of activity would yield more favourable results.

The last argument I want to consider suggests that Government assistance to industry is necessary because of the absence in countries such as India and Pakistan of common facilities such as developed transport and financial systems and a tradition of industrial skill which in developed countries are enjoyed by industrial enterprises. These advantages are sometimes known as external economies, and their absence in underdeveloped countries is often urged as an argument for Government support of manufacturing industry. However, while the absence of external economies is a very real disadvantage, the argument based on it is quite unconvincing. It simply expresses the fact that the economy is not highly developed. But this does not imply that particular industries or types of activities should be assisted. Government assistance involves the transfer of resources from other sectors of the economy. One sector is promoted at the expense of another sector and there is no general argument or presumption that this yields external economies or in some other way promotes economic development. The argument implies that the sponsored or assisted activity represents an equivalent net addition to activity regardless of alternative uses of resources, but it is of the essence of the problem that a transfer of resources is involved. External economies may be made in this particular direction, but other activities contract and external economies are lost there, so that the recognition of the importance of external economies does not offer a general presumption in favour of assisted industrialisation.

In a sense, unfavourable comparisons with manufacturing are generally irrelevant to policy discussions. This is because agricultural production for the market promotes industrialisation, and may indeed be necessary for it, by providing food for the industrial population or by generating cash incomes and thus a market for manufactures, as well as a source of public revenue, which in turn makes possible the production of essential Government services and public investment. The extension of the production of cash crops also serves to acquaint the population with the ways of a money economy and present opportunities and scope for the activities of those endowed with entrepreneurial and administrative talents. When many people have become used to the working of an exchange economy, and when latent entrepreneurial and administrative talents have had time to develop, the additional technical skills necessary for manufacturing can then be acquired more readily than is possible without these advantages. Moreover, development by means of the growth of agricultural production for sale represents less of a break with customary methods of production and existence than the development of manufacturing industry at an early stage, and therefore reliance on it minimises the difficulties of adjustment often present in rapid economic development and thus ease the social and political tensions involved. The rapid promotion of manufacturing industry in an economy which has only recently emerged from the subsistence stage is likely to involve greater social and political tensions than progress from subsistence production to agricultural production for exchange and then to industrial production.

Thus the promotion of economic and efficient industrialisation is much more complicated than is implied in the somewhat crude arguments usually encountered in this realm of discussion. Quite possibly, the best way for Government to foster industrialisation (especially industrialisation which is economic in terms both of the allocation and the growth of resources), may be for it to use more rather than less of its resources to encourage the enlargement of agricultural output and the improvement of agricultural techniques. This may be found paradoxical at first, but on reflection it is really basically quite simple, when it is recognised that the most efficient allocation of national resources is most likely to promote the development of manufacturing industry. No generalisation is possible in view of the diversity of conditions in underdeveloped countries, and even within a single country such as India, and in view of the differences in the level of development attained in different regions. However, it may be suggested with some confidence that in the earliest stages of development suitable assistance to agriculture may be the best safeguard for the establishment and growth of a viable industrial sector, and it can also be said with confidence that the promotion of any uneconomic activity retards the development of economic activity, including efficient and economic branches of manufacturing industry.

But while there is no special merit in manufacturing industry as an instrument of development because manufacturing is but one type of economic activity, it is also incorrect to suggest that without large-scale government assistance, that is without subsidisation at the expense of the rest of the economy, there would be no industrialisation. This suggestion is refuted both by the history of the developed world, and also by contemporary experience of underdeveloped countries. In this connection the rapid growth of manufacturing in Hong Kong is of much interest. Hong Kong has practically no raw materials, nor fuel, nor hydro-electric power, and only a very restricted domestic market. In spite of these limitations, which are frequently alleged to be crippling to unsubsidised industrial development in underdeveloped countries, manufacturing industry in Hong Kong has progressed phenomenally in recent years without any subsidy. It has developed much more rapidly than it has in the other Asian countries where manufacturing industries are usually heavily subsidised. In 1940 there were 800 registered factories in Hong Kong: by now there are over 3,000 employing about 1,30,000 workers. But counting the self-employed and the much larger numbers employed by unregistered factories, there are probably over 400,000 people in manufacturing in a total population of less than three million. The total output of manufactures in Hong

Kong is about £100 million a year, about half of which is exported, mostly textiles, food, drink, tobacco products, rubber and leather ware, electrical products, light engineering products and hardware. About one-half of exports are to non-British territories, where they enjoy no preferential treatment whatever; and apart from the competition in export markets, imports from Hong Kong into the U.K. have become a serious embarrassment to British manufacturers. Official measures are now under consideration to protect the British home market from imports of unsubsidised manufactures from Hong Kong, an underdeveloped country 8,000 miles away.

The problems and merits of government action in the provision of social over-head capital or in accelerating industrialisation have been prominent in the discussions of economic policy for many years. Of more recent origin, are the very influential arguments, prominent in Indian discussions on economic planning, that large-scale socialisation of the economy is indispensable for the promotion of economic development in underdeveloped countries. It is now suggested that the vicious circle of poverty and stagnation as exemplified by the low level of incomes is evidence of failure of private initiative and of market forces and thus of the need for extensive socialisation. For instance, Dr. Gunnar Myrdal writes in *Development and Under-development:*

> "Apparently nobody in the advanced countries sees any other way out of the difficulties, which are mounting in the under-developed countries, than the socialistic one, however differently one's attitude may be towards the economic problems at home."

Nor is this merely academic advocacy, but is also widely accepted basis for policy in the underdeveloped world including India. Thus, according to the Draft Plan-Frame, the first objective of the Second Five-Year Plan is:

> "(1) to attain a rapid growth of the national economy by increasing the scope and importance of the public sector and in this way to advance to a socialistic pattern of society."

In assessing the suggestion, it is important first to remember that the low level of income is not syncnymous with stagnation, but in fact is consistent with rapid growth of economic development. I have already noted that a low level is consistent with rapid growth if that growth has started only recently from a very low level. It is important to remember the difference between a level and a rate of change. Further, it is entirely meaningless to ascribe poverty or stagnation to failure of private enterprise, rather than to unsuitable social and political institutions or to unfavourable economic attitude or qualities of the population, or to lack of resources. For instance, social and religious factors are obviously of major importance in the material poverty of India, and it only confuses the issue to regard this poverty as evidence of the failure of private enterprise. More generally, there is no prescriptive right of development ensuring that all communities should reach the same level of income or rate of development at any given time, or should be caught up simultaneously in the stream of material progress. There is nothing abnormal in differences in these respects, nor does the presence of these differences in economic attainment imply that they will be permanent.

In this context it is often said, both in the underdeveloped world at large and especially in India, that because of the lack of entrepreneurial ability in these countries, the government has to take over functions which elsewhere can be left to private enterprise. There are three links in this chain of reasoning. First of all it suggests that poverty is evidence of stagnation, and secondly that poverty is evidence of the failure of private enterprise. I have already discussed both these arguments. The third link in the chain is the suggestion that poverty is evidence of a lack of constructive entrepreneurship so that it becomes necessary for the government to undertake entrepreneurial functions which elsewhere can be left to private enterprise. Unfortunately, it is rarely made clear from where the government will obtain the supply of entrepreneurial talent if there is none in the economy.

While the vicious circle of poverty and the failure of private enterprise are the twin intellectual bases of the arguments of the most influential school of thought in realm of discussion in India, as elsewhere, the principal conclusions are that comprehensive development planning and compulsory saving are necessary for economic development. Comprehensive development planning, in other words, governmental determination of the composition and the direction of economic activity, is deemed necessary to divert activity into what are called "socially desirable" directions, as distinct from those into which the decisions of individual producers and consumers would direct them. This is regarded as indispensable for economic progress.

Unfortunately again the advocates of comprehensive development planning simply assume that this re-arrangement of resources accelerates economic progress without explaining how this comes about. For instance, Dr. Myrdal writes in his book *Development and Under-development*:

> "The national plans cannot be made in terms of costs and profits for the individual enterprises; they can, in fact, not to be made in terms of the prices of the markets...the whole meaning of the national plan is to give such shelter from market forces to investment, enterprise and production that they become undertaken in spite of the fact that they are not remunerative according to private business calculations.
>
> "It is here that the national state comes in as representing the common and long-term interests of the community at large. It senses the fictitiousness of the private business calculations in terms of costs and profits."

This certainly does not show how the economy is to benefit from the overriding of the decisions of the individuals comprising it. It simply assumes that whatever the state does, represents the true long-term national interest.

The discussion of this range of issues has been much obscured by regarding the sectors, activities or enterprises sponsored by the Plan as equivalent net additions to output or activity regardless of the alternative uses of the resources involved. Yet, quite clearly, the whole process cannot be assessed rationally unless it is recognized that what is involved is the reallocation of resources, and it needs to be shown why this rather than some other use of resources accelerates the growth of output and the rise of living standards.

Within the general framework of comprehensive development planning, proposals for compulsory saving are especially prominent. This is familiar to you from the current Indian literature. Compulsory saving means special taxation designed to accelerate investment expenditure, usually by the Government, apart from the taxation required to finance public investment necessary for the essential Governmental functions. It is often regarded as axiomatic that compulsory saving is necessary to increase output in underdeveloped countries, and further that this increase in output is desirable. However, these conclusions are not obvious.

First, there has been a rapid economic development in many parts of the world without compulsory saving. This is true both of the earlier history of the developed countries, and of the more recent history of many underdeveloped countries. Therefore, compulsory saving is in no way indispensable for economic development. Second, compulsory saving does not necessarily increase either the total supply of capital or total output. It is a transfer of funds from the private to the public sector, and its contribution to the supply of capital is a net factor, after allowing for the repercussions on private capital formation of both the collection and the expenditure of the funds. Very generally, this net contribution is less than the total proceeds of compulsory saving because of the mimimised capital formation in the private sector. It may even be negative if the contraction of capital formation in the private sector exceeds the proceeds of compulsory saving, which is by no means impossible, especially when the process retards the expansion of the exchange economy, that is the progress from subsistence production to production for sale. These considerations are largely ignored in current discussion which often, and indeed usually, regards the proceeds of compulsory saving as an equivalent net addition to capital formation. Yet the process cannot be rationally considered unless it is clearly recognised as a transfer of funds from the private to the public sector. This is not in itself an argument against compulsory saving, but is an essentially relevant consideration for its proper assessment. Moreover, it is relevant not only for the assessment of the economic merits of compulsory saving, but also for its most productive arrangement. For instance, unless the repercussions on the private sector are recognised, it is not possible to design either taxation or the expenditure of the funds in such a way as to maximise the desired and minimise the undesired effects on the economy as a whole. A policy of compulsory saving cannot be framed rationally unless the repercussions on the private sector of both the collection and the expenditure of the funds are recognised.

Let me enlarge on this by means of a specific example taken from West Africa. In Nigeria there are five major export crops, cocoa, groundnuts, palm oil, palm kernels, and cotton. Cocoa, groundnuts and cotton are cultivated products, while palm oil and palm kernels are wild crops; that is, they are collected from naturally occurring jungle trees. There are very heavy export taxes in Nigeria, the proceeds of which are used in part to finance development expenditure. Taxation of the producers of palm oil and kernels does not affect the extension of capacity because, as I have just noted, these are not planted crops. The extension of capacity of the other products is, however, much affected by the price received by producers and thus by the level of export taxes. In fact, the producers of palm oil and palm kernels have been taxed relatively lightly compared to the producers of these other export crops. While political factors and chance circumstances have played a part in this distribution of the cost of taxation, neglect of its effects on the extension of capacity has also played a part. Of course, there are other considerations, notably those of equity, which also need to be borne in mind when framing taxation policy. You will readily recognise that unless the repercussions on the private sector are remembered the policy cannot be rationally and effectively arranged and executed.

Moreover, even if compulsory saving increases the total flow of investible funds this does not necessarily bring about an increase in output. The growth of output is not simply the function of investment expenditure; expenditure does not become productive simply by terming it investment. The facile belief that expenditure termed investment is necessarily productive, and that investment is the essential or even sufficient factor in economic development has been responsible for waste on a colossal scale.

Even if the growth of output is accelerated by compulsory saving, which is not certain, this increase does not necessarily imply desired output, in the sense of goods and services which would have been bought freely by the population. This is because the process increases the proportion of the national output subject to direct governmental control or bought out of taxes, as distinct from output bought on the market by consumers out of freely disposable incomes. Yet if development has a clear meaning as a desirable process, it would seem reasonable that it should refer to desired output, and not simply to any collection of physical goods and services, regardless of consumer demand. And only if the increase in the volume of goods and services represents output desired by people as individuals does it represent a widening of their range of opportunities, of the alternatives open to them as consumers and producers, which is the deeper meaning of economic development. Professor Arthur Lewis says in his book *The Theory of Economic Growth* that the case for economic development does not rest on the argument that it makes people happy, but that it increases their range of choice. With this I agree profoundly. But if output is increased by the exercise of compulsion this does not imply a widening in people's range of choice in the same way as if it has been brought about without such compulsion.

Compulsory saving and comprehensive development planning generally imply far-reaching centralised governmental control over the lives, activities, and sources of livelihood of people, with pervasive social and political results. They imply societies in which there are great inequalities of power, in that some individuals and groups have far-reaching powers over others, whose access to alternatives in both the earning and spending of their incomes is greatly restricted. The great increase in the prizes of political power which stems from these measures, enhances the intensity of the political struggle in under-developed countries, which is particularly manifest in plural, multi-racial societies. One reason why the political struggle is so intense at present in many parts of the under-developed world is that so much is at stake, because the government controls people's lives so closely. Such pervasive and far-reaching policies as comprehensive development planning and compulsory saving must be judged largely on the basis of a political position, and only in part on technical economic reasoning. Their assessment depends very largely on what kind of society you prefer, which is not a technical economic matter. But at both levels, that is on a political level and on technical economic reasoning, it is relevant to remember that such policies are not generally indispensable for economic development, that they may not increase output, let alone desired output, and also that there has been much development in both the developed and the under-developed world without such policies. Indeed, not one of the now highly developed countries had to resort to these methods in the earlier stages of their development. It is only in the Soviet economies that comprehensive development planning and compulsory saving have been adopted as the central instrument of economic advance, and the characteristics of these societies reflect the progressive nature of these policies.

Let me now sum up. The under-developed countries which comprise over two-thirds of the world represent a vast aggregate, much more diverse than is often realised. The vicious circle of poverty and stagnation which is the keystone and leading theme of current discussion is manifestly invalid as a general proposition. A low level of income does not imply stagnation, and is indeed compatible even with rapid economic advance. Poverty or a slow rate of development are evidence neither of an abnormal situation nor of failure of private initiative. The policies now being proposed by the most influential current school of thought do not ensure an increase in output, and even if they did, this would not necessarily mean economic improvement for the masses. On the other hand these proposals have far-reaching and pervasive political and social results, in that they promote societies with great inequality in power in which the lives and activities of the population are closely controlled by the government.

You will probably expect me in conclusion to say something more positive and specific about policies for relieving poverty and accelerating development in under-developed countries, especially India. I am indeed tempted to do so. But I think it would be a mistake to yield to this temptation and to advance specific proposals for policy. I think this for the following reasons. Generalised policy recommendations applicable to the under-developed world as a whole would either have to be so vague as to be uninteresting or, if they were more specific, they would fail to take account of the essential diversity of these countries, and I do not know India sufficiently to propose specific policies. The merits both of particular measures and of more general policies depend on their effects on the total social situation and not only on those aspects with which economies are primarily concerned. It is also necessary to take into account social, political and administrative possibilities when proposing courses of policy. More fundamentally, policy recommendations are deeply influenced by political positions and value judgments, especially one's view of the kind of society one prefers. For all these reasons, I think it would be inappropriate for me to be drawn into discussion of policy. But I may, perhaps, be permitted to make some bold remarks which bear on development policy in many under-developed countries including India, even if they do not amount to recommendations for specific policies.

First, there is a wide range of tasks in under-developed countries as elsewhere which necessarily devolve on the government. These include the promotion of a suitable institutional framework for the activity of individuals, the maintenance of law and order; the control of the supply of money; the provision of basic health, and educational services, transport facilities, and of agricultural extension work; and certain other tasks as well. The adequate performance of these functions exceeds the resources of governments of all under-developed countries which I know, even without such ambitious aims as comprehensive development planning and the like. At present we are faced with the paradoxical situation that governments engage in ambitious tasks when they are unable to fulfil even the elementary and necessary functions of government, functions which necessarily devolve on the government because they cannot be undertaken by the private sector.

Some of these necessary tasks are of great importance and complexity, especially the provision and improvement of the institutional framework of economic activity. Institutions suitable for the efficient operation of the economic system do not necessarily emerge from the operation of the system itself. The economic endeavour of people is likely to be frustrated unless the institutional structure is suitable for the efficient performance of their tasks, and is moreover continuously adapted to changing needs. For instance, the market cannot be expected to bring about a suitable law of property, or institutions such as that of limited liability. In the early stages of economic advance, notably in the development from subsistence to a market economy, the development of a suitable institutional framework poses formidable difficulties. The provision of such a framework necessarily devolves on the government as the executive organ of the community. Similarly, expenditure yielding benefits indiscriminately devolve largely on the government because the individuals benefitting cannot be made to pay directly for these services. The provision of national defence, justice, basic transport and other facilities are familiar examples.

Secondly, I want to remind you again that if development is to be meaningful as a desirable aim of policy it cannot refer simply to the growth of output of physical commodities unrelated to the wants of individuals comprising the society. I realise that this involves a value judgment. This value judgment is the attachment of meaning and significance to individual valuations and desires. There are many people, including prominent figures in India, who think that individual valuations are meaningless. Accordingly they are prepared to disregard such valuations in discussions of the process of economic development. I reject such an approach. But I recognise that this rejection stems from a political position and not from technical economic reasoning.

Third, the rapid development in recent years of many under-developed countries shows that the forces which promoted progress in the early history of the developed countries are often present in under-developed countries, unless obstructed by specially unfavourable social arrangements or political measures.

You will see from these few remarks that I envisage extensive governmental functions in under-developed countries, the adequate performance of which poses formidable problems. It is regrettable that so much of current discussion obscures rather than elucidates many of these problems and thus makes their solution more and not less difficult.

Much of what I have said to you runs counter to the most influential current ideas on the subject. If I am shown to be wrong, I shall have to reconsider these arguments. But the fact that they are politically unpopular has no bearing on their validity. I will close by quoting some remarks of Alfred Marshall which should be borne in mind both by those who are engaged in the study of under-developed countries, and by those who wish to influence policy.

> "While taking an attitude of reserve towards movements that are already popular, you will incline to be critical of prophecies that are fashionable."

And he also realised the results of such an attitude:

> "Students of social science must fear popular approval; evil is with them, when all men speak well of them....It is almost impossible for a student to be a true patriot and have the reputation of being one at the same time."

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CENTRAL PLANNING AND ECONOMIC DEVELOPMENT

By
Prof. P. T. Bauer

INTRODUCTION

This is the text of a public lecture delivered under the auspices of The Murarji J. Vaidya Memorial Trust in Bombay on the second of February, 1970. The text is a transcript from a tape recording unedited by the author. Prof. Bauer is a well-known authority on the economies of underdeveloped countries. He is at present a Professor at the London School of Economics. An enlarged version of this theme will appear in Prof. Bauer's forthcoming book, "Dissent on Development".

The Murarji J. Vaidya Memorial Trust was set up to perpetuate the memory of the late Mr. Murarji J. Vaidya, well-known industrialist and economist, who was associated with the formation of the Forum of Free Enterprise in 1956 and who was its President from 1965 to 1968. Mr. Vaidya was associated with the late Sir Mr. Visvesvaraiya in setting up the All-India Manufacturers' Organisation and was its President for some time. Among the numerous public offices he held are Presidentship of the Indian Merchants' Chamber and the Indian Council of Foreign Trade. A selection of his writings has been published under the title "Objectives of Planning and Other Essays" by Popular Prakashan, (Bombay-34), and is priced at Rs. 15|-.

I should like to begin by saying how very much I appreciate the honour to be invited to give the first of the Murarji Vaidya Memorial Lectures i.e. the first in a series, which I have no doubt, will be an exceptionally distinguished series of Lectures. The fact that you chose to invite somebody who is not an Indian and whose views are known to be extremely unpopular indicates an independence of mind, a freedom of thought, which I think is most impressive and which greatly adds to my pleasure of being here.

What I want to do on this occasion is to examine the idea that Comprehensive Central Planning, in the sense of State control of the composition of economic activity, outside small-scale agriculture, is indispensable for the economic development of poor countries. The thesis that Comprehensive Central Planning, in this sense, is imperative can be illustrated with passages from numerous writers. I shall confine myself to two of these.

First, Professor Gunnar Myrdal, perhaps the most influential and explicit exponent of the axiomatic necessity of this policy, says in a book entitled "Development and Underdevelopment":

"It is now commonly agreed that an underdeveloped country should have a national economic development policy. Indeed, it should have an overall integrated national plan, as is also urged by everybody.

"............ the national government is expected to assume by means of the plan, and the co-ordinated system of state interference making up the operational part of the plan, responsibility for the direction of the entire economic development of the country.

"The emergence of this common urge to economic development as a major *political* issue in all underdeveloped countries and the definition of development *as a rise in the levels of living of the common people,* the uncontested understanding that economic development *is a task for the governments* and that the governments have to prepare and enforce a *general economic plan,* containing a system of intentionally applied controls and impulses to get development started and keep it going, is an entirely new thing in history........

"Central economic planning is always a difficult thing and, when it has been tried, it has not been too much of a success in the advanced countries. Now, what amounts to a sort of superplanning *has* to be staged by underdeveloped countries with weak political and administrative apparatuses and a largely illiterate and apathetic citizenry.

"These are all reasons to expect numerous mistakes and in many cases total failure. *But the alternative to making the heroic attempt is continued acquiescence in economic and cultural stagnation or regression which is politically impossible in the world of today;* and this is, of course, the explanation why grand scale national planning is at present the goal in underdeveloped countries all over the globe and why this policy line is unanimously endorsed by governments and experts in the advanced countries."

Prof. Myrdal's statement, that all experts are unanimous on this suggestion is simply untrue. There are a great many prominent economists—for example Prof. Milton Friedman, former President of the American Economic Association, and perhaps the foremost American economist today, who knows the underdeveloped world of today, and who radically disagrees with this idea.

A much more succinct formulation of the alleged axiomatic necessity of Comprehensive Planning is by a

Professor of the Tokyo University. He says: "Only planned economic development can hope to achieve a rate of progress that is politically acceptable and capable of commanding popular enthusiasm and support." This opinion is ironical in the light of the phenomenal progress of Japan, which was achieved without the policies he specified as indispensable.

These, of course, are not the views of academic advocates only. Comprehensive Central Planning is of the essence of economic policy in many parts of the underdeveloped world, notably so in India. And because such a policy is widely regarded as a condition of economic advance, Governments pursuing or proposing to pursue it, are treated preferentially in the allocation of foreign aid.

Planning is one of those concepts like love, freedom, democracy, equality or civilisation, which can be given a number of widely different meanings. Planning can mean orderly preparation for the future conduct of persons, enterprises or Governments. The term can be used to prescribe the coordination of the activities of different Government Departments to reduce competition among themselves for scant resources. It can denote plans to phase fiscal policies to off-set fluctuations in private expenditure. But in the contemporary development literature it refers to actual or attempted State control of the economy, outside subsistence agriculture, in particular, of the composition of economic activity.

Prof. Myrdal defines the tasks of planning as follows:

"The plan must determine this overall amount of investment and must, in addition, determine the proportions of the capital which should be allocated in different directions: to increase the overall facilities in transport and power production; to construct new plants and acquire the machinery for heavy industries and for light industries of various types; to raise the productivity level in agriculture by long-term investments in irrigation schemes and short-term investments in tools, machinery and fertilisers; to improve the levels of health, education and training of the working people, and so on. To be practical and effective, the plan must be worked out not only as a general frame, but must have this frame filled and concretised by careful segmental planning. And it must contain definite direction on all points, and in addition spell out instructions for the specific inducements and controls by which the realisation of those directives becomes effected."

In short, Comprehensive Central Planning means the state determination of the composition of most of the economic activity.

Although advocates of comprehensive planning regard it as axiomatically necessary, there is no ground whatever for this notion. Such a policy played no part in the development of any one of the West European countries or of Great Britain or of North America or Austrialasia. Nor did it play a part in the substantial progress of many underdeveloped countries and areas which have advanced substantially since the end of the 19th century, such as Japan, Hong Kong, Malaysia, Thailand, West Africa and many others. This progress is often overlooked in the current discussions for two reasons :

1. People often treat the so-called underdeveloped world as a homogeneous stagnant collectivity.
2. Much of the current discussion confuses a low level with a zero rate of change. In many underdeveloped countries the level of income is still low but nevertheless there has been rapid material advance, which has begun, comparatively, very recently and started from a very low level.

It is not at all surprising that comprehensive planning should have played no part in the development of either Western Europe or of North America or in the progress of many underdeveloped countries, which have advanced in the course of last century. Comprehensive planning does not augment resources. It only centralises power. In fact, it not only centralises power, but actually creates power. In a decentralised system of decision-making, there does not exist such power as is created by comprehensive planning. Power here means in any meaningful sense the capacity to restrict the choices open to people. In a market system, there are large corporations and rich men who accumulate resources usually built up by meeting consumer needs. But their riches do not confer on these people or on the corporation power to restrict alternatives and choices open to other people, such as civil servants and politicians have under the system of comprehensive planning.

This creation and centralisation of power is rarely discussed by the advocates of comprehensive planning. For instance, although its outcome is clear from the passages which I quoted from Prof. Myrdal, he does not mention it. On the other hand, the same advocates of comprehensive planning manage to imply somehow that the policy will create new and additional resources, without making it clear where the resources are to come from. The State cannot create new and additional productive resources. The politicians and civil servants who direct its policy only dispose of resources diverted from the rest of the economy. It is certainly not clear why the over-riding of the decisions of private persons should increase the flow of income, since the resources used by the planners can only be diverted from other productive public and private uses. It is even less obvious why the flow of goods and services, which are desired by consumers, and which make up the standard of living, should be given an increase by such a policy. For example, Prof. Myrdal insists that a rise in general living standards must be the aim of development policy. But he does not say how his policy of control would bring this about. And, indeed, later in the lecture, he writes that comprehensive planning implies utmost austerity!

Comprehensive planning, in my opinion, is much more likely to retard material progress, in the sense of a general rise in living standards than it is to promote it. But before I discuss this matter, I wish to digress on three points.

1. I want to note briefly a re-interpretation of the concept of planning which has made its appearance recently in literature. An example is provided by the central argument — again of Prof. Myrdal's monumental book, "Asian Drama". His reformulation of planning envisages enforced wholesale transformation in values, attitudes and institutions of people by coercion, if necessary. This type of interpretation of planning envisages the policy as an attempted compulsory transformation of man and society. It is no longer the state control of economic activity. It is the re-making of man and society. It is an attempt to remould people's beliefs, values, attitudes, institutions and even their faculties. I think, if such a policy was pursued and pressed, it would reduce the population to the status of malleable clay to be moulded at the will of the rulers. A population so treated is more likely to become an inert mass, rather than a vigorous society capable of material progress. It is very doubtful how far the indigenous governments of most underdeveloped countries, i.e., governments

drawn from the local population with basic faculties and values they share, at least in part, would attempt such coercive, wholesale transformation. They are more likely to content themselves with close control over economic life.

2. I should like to note, briefly, a crazy technical argument, often introduced in the discussion on the merits of comprehensive planning. Most of the contemporary discussions take the case of contemporary planning for granted. Sometimes specific arguments are put forward in support of this policy. The most widely canvassed of these is that comprehensive planning is required to increase investment expenditure to levels necessary for an acceptable rate of development. This argument is irrelevant. To begin with, much of planning is not even designed ostensibly to increase the rates of saving and investment. This applies, for instance, to commercial and industrial licensing. Indeed, major constituent elements of comprehensive planning restrict saving and investment. Examples include the restrictions on the operation or on the expansion of industrial enterprises or the restrictions on the inflow and deployment of foreign capital. These policies are widespread in countries where comprehensive planning is the official policy. Again, saving and investment can be encouraged by various fiscal, financial policies and also by measures designed to promote institutional change without recourse to comprehensive planning. Therefore, the suggestion that comprehensive planning is necessary for raising investment expenditure is irrelevant. And this consideration is quite apart from the question of the relation between investment expenditure and material progress or apart from the merits of compulsory savings for development. These are matters that are pre-judged in the advocacy of comprehensive planning as a policy for promotion of material progress.

3. The third preliminary point is that people's faculties and attitudes are ignored by proponents of centralised planning. It should be clearly understood that these references are solely to those attitudes, motivations and beliefs which promote material success, which are not necessarily or even usually those that confer happiness, dignity, sensitivity, sense of harmony, capacity to love or reflective turn of mind. This point is important and is widely overlooked.

I wish to reiterate that the axiomatic assumption that comprehensive planning, in the sense of state control of the composition of economic activity, is necessary for material progress, is groundless. Nor is there any general reason for the belief that such a policy normally promotes material advance. Why should it indeed? And there are many reasons why it should retard it, which is what the empirical evidence shows. An economy consists of people whose material needs the economy has to satisfy and whose performance largely determines the material achievement and the rate of advance of the economy. This is a platitude. The implications and corollaries of this platitude are much neglected in discussions on economic development. The prime corollary of this platitude is that economic achievement depends primarily on people's faculties, aptitudes and also on social and political institutions. It follows from this that differences in these determinants or factors largely explain differences in the levels of economic achievements and in the rates of material progress. People's economic faculties — I use "faculties" as synonymous with capacities. qualities, aptitudes, motivations, values and beliefs, and the social and political institutions which largely reflect these, are the mainsprings of material progress. Natural resources and external market opportunities also play a part. However, with the exception of climate, and its effect on performance, economic faculties are a significant natural resource rarely discussed as such. Natural resources have been only of secondary importance, both in the development of advanced countries and in the development of many underdeveloped countries, since the 19th century. And the exploitation of both the natural resources and external opportunities must depend on the required human faculties and institutions.

Capital resources, which are often thought crucial, are usually less important. And, in any case, their availability and productivity reflect personal capacities and motivations and social and political institutions. These resources as a result are a dependent variable in the process of economic development rather than a cause or an independent variable. But even if the supply of investible funds were a key, independent variable in the development process, which it is not, the need to increase their volume is irrelevant to comprehensive planning, for reasons which I have already noted.

Intellectual, artistic and aesthetic activity, achievements and differences in achievements, depend clearly on personal faculties and motivations. This connection is always recognised and taken for granted. The corresponding connection in economic activity is much less readily recognised. There are various reasons why people recognise this relationship in many other activities but not in economic life. The most important reason is, perhaps, that this desregard in the differences in the economic aptitude and attitudes spuriously justifies far-reaching proposals for compulsory standardisation of material conditions. Such proposals of compulsory standardisation gain in plausibility if differences in economic achievement are treated as a result either of environment or of chance, since these proposals then appear to be just practicable and neutral in their effects on material progress.

Which are the factors which underly the determinants of development, or which account for geographical or ethnic differences in their operation? These are matters which are much disputed and about which, in fact, very little is known. Similarly, both the origin of these differences and the likelihood of their persistence are often conjectural. What is not in doubt is the presence or at least the comparative strength, in many underdeveloped countries, of long-standing attitudes, beliefs and cultural traditions uncongenial to material advance, and often also, a relative weakness of personal faculties favourable to it.

I could give a few examples of the factors unfavourable to material progress which are often encountered in underdeveloped countries. For example, they include a lack of interest in material advance combined with resignation in the face of poverty; a lack of initiative, self-reliance and a sense of personal responsibility for the economic provision of oneself and one's family; the presence and prevalence over long periods, in Asia specially, of an authoritarian tradition much stronger than in the west, which discourages self-reliance, experimentation, curiosity and a desire for change; a high leisure preference; a high preference for comtemplative or passive life, compared to an active life; the acceptance of a pre-ordained, unchanging and unchangeable universe; and emphasis on the performance of duties and on the acceptance of obligations rather than on the achievement of results or the assertion of personal rights; belief in the efficacy of the supernatural and occult forces and of their influence over one's destiny; insistence on the unity of the organic universe and of the need to live with nature, rather than try to conquer it or harness it to man's end, an attitude which often leads to a reluctance to take animal life.

This list, of course, could be extended greatly. The presence and significance of these personal and cultural factors are ignored when the peoples from the underdeveloped society are regarded as being uniform and being very much like the population of the developed countries except for being poorer. If the only relevant difference between people were that in income, it would not prevail for long or probably would not have emerged at all. But there are pronounced differences in the determinants of material progress between persons, groups and societies throughout the world, both within the developed world and within the underdeveloped world. These diversities are ignored when the underdeveloped world is treated as a substantially uniform and largely stagnant collectivity, the conspicuous characteristics of which are regarded as being basically similar among themselves, and different from those of the developed countries, only in being poor.

I want to make it clear, that although I do emphasise the importance of these determinants in the development in different nations, I ought to say that we cannot say for how long these differences are likely to persist. That they are not fixed for all time is shown by the ever-changing relative position of different countries in the commercial and economic league, so to speak. The changes in economic and commercial leadership and the phenomenal progress of Japan in the last century is just an example.

Climate may have played a part in the emergence and in the persistence of some of the attitudes and modes of conduct adverse to material advance. The concentration of material backwardness in the tropics, and numerically in other extreme climates, would suggest that prolonged residence there, affects adversely, at least for a time, the determinants of material progress. The enervating effects of extreme climate on physical and mental activity have often been noted in the past, and in this regard it is evident that climate is almost certainly responsible and partly explains the lassitude of large sectors, almost all, of the population of East Asia. And these effects of a tropical climate have been reinforced by the loyal authoritarian tradition of South Asia.

As I have already said, reflections on the persistence of some of these adverse factors must be speculative, conjectural. But it can be said with some confidence that comprehensive planning reinforces the influences which inhibit material progress in these countries. Economic development requires a modernisation of the mind.

It requires a revision of the attitudes, modes of conduct and institutions which retard material progress.

Comprehensive Planning reinforces the authoritarian tradition in the underdeveloped societies, a tradition which generally inhibits faculties behind material advance. In this context, I always have to say *generally,* because somebody can always think of the exceptions for continuing and extending State control over the lives of the population. Central planning reinforces the subjection of the individual to authority. It thereby goes counter to that liberation from authority which encourages the attitude which usually promotes material advance. In particular, it discourages or even suppresses personal self-reliance and personal provision for the future.

Comprehensive Planning means close economic controls. This is the essence of the policy. And these controls in turn restrict occupational and geographical mobility, which inhibits the establishment of new contacts, the spirit of experimentation and the opportunity to set up new enterprises. Mobility and experimentation promote material advance in familiar ways, including the erosion of the attitudes and customs adverse to material progress. These controls under comprehensive planning invariably, and indeed necessarily, extend the restrictions on external economic relations, including migration, trade and capital movements. These contacts normally serve as channels and vehicles, not only of human resources, physical commodity and financial transactions, but also of new ideas and attitudes, crafts, methods of production and wants. These contacts have often served to engender altogether a new outlook towards material progress: A new outlook brought about by voluntary adjustment to new opportunities without the cost of coercion.

The strong general presumption that such policies hinder material progress is reinforced by the character and methods of operation of major controls under comprehensive planning. The principal controls include State monopolies in industry and trade, extensive licensing of industrial and commercial activities, including imports, exports and foreign exchange, and the establishment of many Government owned and operated enterprises including State supported and operated so-called Co-operatives. Some of these measures give Governments, particularly export monopolies, close, direct control over the livelihood of the people. They also serve as a powerful source of patronage and finance for the rulers. Such policies, therefore, greatly restrict the alternatives open to people in these societies, notably the opportunities to set up independent enterprises and choose between different employers. Eventually, these policies bring about tightly controlled economies in which people's lives and activities, and the opportunities and choices open to them as producers, consumers, workers and traders depend largely on the Government.

Such measures have nothing to do with raising popular living standards. Indeed they usually depress them. Lip service is paid to the improvement of living standards as a objective of comprehensive planning. But this objective is rarely used as a test of official policies. The extensive controls and the heavy taxation imposed under comprehensive central planning are not only unrelated to the raising of the general living standard, the ostensible aim of development planning, but are generally contrary to these aims.

Comprehensive Planning often promotes political tension, at least until such a point when all political opposition is suppressed. When State power is extensive, the achievement and exercise of political power becomes a matter of widespread anxiety and acute concern, particularly among the active elements of the population. The stakes in the fight for political power increase and the struggle becomes intensive when the State has all-important powers in social and economic life. Such powers enhance political tension, particularly in multi-racial societies. They also divert the activities and energies of able and ambitious men from economic activity to the political sphere.

However it comes about, concentration of power and extension of State control over people's life necessarily follows comprehensive central planning. A prospective rise in income or in the standard of living, as a result of such policies, is improbable and rests on unsubstantiated assertions. Concentration of power is a necessary result of comprehensive planning. The idea that it will somehow raise income and general living standards is simply unsubstantiated assertion for which there is no general basis in logic or indeed empirical evidence.

The adoption of comprehensive planning has nowhere served to raise general living standards. Indeed these are extremely meagre in countries where this policy has been pursued longest, and almost certainly much lower than they would have been under different economic systems. It is, of course, in the Soviet type of economy that Comprehensive Central Planning is, and has for decades been, central to economic policy. And after decades of operation it has not benefited general living standards. On the other hand, the nature and texture of these societies reflect the basic character of this policy. Moreover, these countries tend to have strict frontier control to prevent people from leaving, which suggests widespread dissatisfaction and disillusionment with the material and non material conditions created by central direction.

Any Government which closely controls the economy can readily expand particular sectors and activities of the economy by extracting resources from the population or transferring these from other sectors. Such Governments can, therefore, enlarge particular indlstries and sectors of economy. They can erect impressive monuments and create substantial military machines. But such developments have nothing to do with a general rise in the living standards as the people of Eastern Europe know only too well. As a matter of fact, this is now implicitly recognised in the West by supporters of the Soviet system, because the Western economic systems are now frequently criticised by supporters of the comprehensive planning and the Soviet system, as being consumer societies, and this is regarded as a term of contempt.

Now these criticisms of comprehensive central planning as allegedly indispensable for development should not be regarded as a criticism of all governmental functions. In fact, preoccupation with central planning has paradoxically contributed to a serious neglect of essential governmental tasks in underdeveloped countries. Let me now consider briefly, what I think the essential Government tasks are. These would include the management of external affairs to the best interests of the society, the maintenance of law and order, effective management of the monetary and fiscal system, the promotion of suitable institutional framework for the activities of the individuals, the provision of basic health and educational services, and basic communications and also agricultural extension work. These functions are important or even essential and they cannot be performed by the private sector or individual companies partly because they refer to the institutional structure, within which the private sector functions, and this must be established by law. For example, the market system cannot create a law of limited liabilty. And second, some of these functions relate to activities for the output of which there may be a demand, but it cannot be bought and sold in the market, for instance, the provision of national defence.

It is by the discharge of these tasks that Governments can best develop the framework, within which the people can improve their living standards, if that is what they want and if they are prepared to develop the modes of conduct and attitude necessary for it. This list of tasks largely absorbs the potentialities of Government action in the promotion of living standards. Moreover, the adequate performance of these tasks would fully stretch, if not exceed, the resources of all Governments in poor countries. It would exceed the human, material and financial resources of all Governments of poor countries. In fact, what we see throughout the underdeveloped world, sometimes in very extreme forms, as in Indonesia or Burma, is that the Governments which attempt closely to control the economies of their countries, quite generally neglect even the most elementary of these functions. The Governments seem anxious to plan and they are unable to govern. The adequate performance of these essential Governmental functions would exceed the resources of Governments of poor countries. But these functions do not normally imply close control over people's lives and activities. This is merely one reason why the advocates of comprehensive planning are often unperturbed when Governments engaged in central planning neglect these elementary functions. The planners seem more interested in controlling people's lives than in augmenting their resources or liberating their minds.

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REFLECTIONS ON FOREIGN AID

By

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It is a major axiom of the current development literature that Foreign Aid, in the sense of inter-Governmental grants, or subsidised loans in cash or kind, are indispensable for the material progress of poor countries. This argument or axiom is often coupled with the suggestion that foreign aid by the Western countries is a discharge of a moral obligation to help the poor.

Foreign aid in the sense of inter-Governmental grants and subsidised loans is a system of doles. A contemporary discussion on aid is pervaded by the view that such a system of doles is necessary for the progress of poor countries. A convenient formulation of this view is presented by a passage in a letter by Prof. Wolfang Friedman of Columbia University, who is not to be confused with Prof. Milton Friedman. The letter which appeared in "The New York Times" says: "It is the unanimous opinion of all foreign aid experts that the total amount of development aid is grossly inadequate for even the minimum needs of developing countries." Thus, according to Prof. Friedman, economists who dispute the necessity for foreign aid. cannot be experts in this field. Yet, there are many economists of widely different political views — some in prominent positions — who dispute this contention. For example, Prof. Milton Friedman, who is an economist of some prominence, and Prof. Joan Robinson, who may be known to some of you and whose views differ greatly from those of Prof. Milton Friedman in most subjects, are in agreement that foreign aid is certainly not necessary and is actually harmful for under-developed countries.

The idea that foreign aid is indispensable for the progress of under-developed countries seems to be derived from the idea that without aid these countries are so poor that they cannot save and invest enough for the capital formation necessary to raise their income. But foreign aid is obviously not a generally necessary nor a sufficient condition for economic advance. It is clearly not a generally necessary condition for economic development as is obvious from the very existence of developed countries. All developed countries began as under-developed countries and progressed without foreign aid. Moreover, many under-developed countries have advanced very rapidly over the last 70 or 80 years without foreign aid, which is the particularly relevant consideration in this context. There are many such countries in the Far East, South-East Asia, East and West Africa and Latin America. So aid is clearly not a necessary condition for economic development nor is it a sufficient condition. Foreign aid, for example, cannot promote development if the population at large is not interested in material advance nor if it is strongly attached to values and customs incompatible with material progress. An instructive example is provided by the results of the large scale American domestic aids to their Navojo Indian population. The Navajo Indians are a large group with their own territorial government. Since about 1900, vast sums have been spent by the United States Government, in attempts to improve the material position of this group, with no perceptible result.

There are many examples from the experience of the last decade or two of the comparative ineffectiveness of foreign aid as an instrument for raising general living standards in poor countries. Fifteen years after the inception of Western aid and the Five-Year plans, India in 1966-67 experienced the most acute of its recurrent food and foreign exchange crisis. India has been dependent for large scale foreign aid and gifts of food for so long now, that this external dependence has come to be taken for granted. Indeed the economic history of India since about 1956 can be summarised as a progression from poverty to pauperism. Yet, it was an explicit objective of Indian planning to reduce or eliminate economic dependence. Now after well over a decade or foreign aid its general ineffectiveness to promote living standards in poor countries is freely recognised in current discussions.

The advocates of aid, however, at the same time insist on more foreign aid. Supporters of foreign aid regard the absence of an appreciable improvement in the economic conditions of recipient countries as an argument for extending foreign aid both in volume and in size. The case of foreign aid is treated as axiomatic. Once you treat a case as axiomatic, then empirical evidence becomes irrelevant. Because, take for example foreign aid — either progress or lack of progress can be used as an argument in support of its continuation or expansion. Progress is evidence of its success, and lack of progress is evidence for the need for more! Foreign aid is thus, indisputably, neither a necessary nor a sufficient condition for advance from poverty.

When foreign aid is likely to promote or retard development cannot be established so clearly. This is because the economic situation, and its rate of change at any given time or any given period are affected by so many different factors that it becomes very difficult to disentangle the specific effects of aid. Further, it is impossible to know what policies would have been pursued in the absence of aid. For these reasons, before saying that the foreign aid is likely to accelerate or retard economic development — it has accelerated or retarded development over the last 15 years — it is necessary to proceed by reference to certain general considerations supplemented by specific empirical evidence. However, the difficulty of ascertaining whether in a particular situation foreign aid has promoted or retarded the progress of a particular community may be difficult, but it can be said conclusively that it is neither a necessary nor a sufficient condition for material progress.

I believe that the flow of aid since the Second World War has probably more retarded than promoted the overall economic advance of recipient countries. This conclusion is paradoxical,. It is paradoxical, because foreign aid certainly increases the resources of the recipient countries or, at any rate, of their Governments. But it does not follow from this that foreign aid increases the rate of development. This result depends on how aid affects the determinants of economic progress, notably its repercussions on economic attitudes, policies and institutions and also on the allocation of resources in the recipient countries. The repercussions are often damaging in practice and tend to outweigh any favourable results of the inflow of resources. This is the reason why foreign aid, though it may improve current ecenomic conditions in the recipient countries, has not served generally to promote their economic development.

The major determinants of material progress are people's economic faculties and motivations and the social and political institutions which reflect these faculties and motivations. Foreign aid is relatively ineffective as an instrument of development because, even at best, it cannot affect these underlying determinants of development favourably. If a country, or rather a people, cannot develop without external doles, it is unlikely to develop with them. Advocates of aid encourage the unfounded belief that the pre-requisites of development can be had for nothing and they ignore or obscure the fact that the populations of developed countries themselves have had to develop the faculties, attitudes and institutions favourable to material progress.

At this juncture of the discussion somebody is bound to raise the question of Marshal Aid because this is often quoted as an example of the effectiveness of foreign aid. But the analogy between Marshal Aid and the aid-programme for under-developed countries is false. The economies of Western Europe had to be restored, while those of the present recipients have to be developed. The peoples of Western Europe had the faculties, attitudes and institutions favourable for development for centuries before the Second World War. Hence a rapid return to prosperity in Western Europe and the termination of Marshal Aid after four years, in contrast with the economic plight of India and of many other recipients of aid after a much longer period.

Persons and groups react to material poverty and backwardness in different ways. They may not even notice the condition. Such an attitude is often a part of a wider attitude of an unquestioning acceptance of the nature of things, especially, if comparisons with other people are not readily available. They may consciously accept poverty, either in the form of resignation or unwillingness to change modes of living, or they may improve their position by relying on charity or beggary. Finally they may attempt to improve their own economic performance. Only the last of these responses can lead to sustained material progress. And it is the one least likely to promote it by insistence on foreign aid as allegedly necessary for material advance. Moreover, the way the advocacy of foreign aid is presented often sets up unfavourable repercussions within the recipient countries.

It is often said or implied that the West owes foreign aid to the under-developed countries as evidenced by its riches. It is suggested that the riches of the Western countries have somehow been extracted from the under-developed countries, while in fact they have been generated in the West. And if you suggest that riches are extracted from other people, then you suggest before very long that within the underdeveloped countries the better-off people owe their prosperity somehow to the exploitation of the rest of the society. This then sets up attitudes and results which are harmful to material progress.

Certain differences between resources developed locally and resources supplied gratis, as external doles from abroad, are relevant to an assessment of foreign aid. When resources are both generated and used locally the personal faculties and attitudes, social institutions and economic opportunities are encouraged to develop simultaneously, and to serve as they see for further material progress. This beneficial inter-relation is missing when resources are supplied gratis from abroad. Moreover, external doles tend to bias development in directions based on inappropriate external prototypes. And the adoption of external prototypes in development policy is often damaging, and it may retard rather than promote material progress, lead to frustration and political tension. Inappropriate, external prototypes come to be adopted in political life, legal system, the organisation of the Civil Service, the establishment of Western type Universities, as well as in technology and forms of industrial and commercial organisations.

The establishment of Universities based on Western models, when there are no employment opportunities for their graduates, is a familiar example. And adverse results are all the more likely when the expenditure is undertaken by people who do not themselves bear the cost. The impact of foreign aid in biassing development policy and strategy in directions based on inappropriate external prototypes is an instance of the wider issue of the problem of transferring institutions between different cultures and societies.

Foreign aid augments the resources of Governments compared to those of the private sector in recipient countries. This effect promotes concentration of power within under-developed countries, increases the weight of the

Government in the society and economy and thereby promotes a concentration of power. This effect is greatly reinforced in the current political scene by the preferential treatment in the allocation of aid to Governments engaged in Comprehensive Planning. This criterion in the allocation of aid is based on the belief that comprehensive planning is necessary for economic progress, so that its adoption by Governments is seen as evidence of the earnest of the Governments to promote it. Indeed in much of current discussion, planning is equated with development. This notion is opposite of the truth. Comprehensive planning is demonstrably not a necessary condition of economic development and is much more likely to retard than to promote it. However, Governments engaged in comprehensive planning are preferentially treated in the allocation of Western aid. Moreover. the flow of aid is often linked to the balance of payments deficits of the recipients. This is particularly so when these deficits are regarded, as they often are, inevitable concomitants of Government's efforts to carry out development plans. Governments are thus encouraged to make their development plans as ambitious as possible, to pursue inflationary monetary and fiscal policies and to avoid the accumulation of foreign exchange reserves. The pursuit of inflationary policies, the recurrence of balance of payments crisis, the imposition of specific controls, notably exchange controls and high taxation, usually lead to a widespread feeling of insecurity. This insecurity and crisis-atmosphere, which is engendered, encourage the export of capital, and discourage domestic savings and investment expenditure so that the inflow of foreign aid is matched by a reduction in the rate of domestic savings and investment, and by an outflow of private capital. Often private capital is much more productive than the capital represented by this external doles. But foreign aid may even reduce, rather than increase the investment expenditure within the recipient countries.

Foreign aid is also likely to discourage recipient Governments from seeking capital abroad on market terms. It is politically unwise, and may indeed be even suicidal, to pay market terms, if foreign aid, that is funds secured gratis, or on heavily subsidised terms, are available. And practically all recipients of foreign aid impose severe restrictions on the inflow and deployment of private capital, although they often pay lip service to its usefulness.

Preoccupation with foreign aid, central planning and investment expenditure has encouraged the facile belief that material advance is possible without cultural change.

This belief has in turn inhibited the exploration of ways to promote institutional changes, especially change without coercion. In the sphere of institutional change, the recipients of large-scale foreign aid have, so far, largely confined their activities to the expropriation of politically weak and unpopular classes in the name of land reform, social justice or the removal of alleged exploitation. Such measures have generally retarded economic development.

A variant of the case for foreign aid to promote investment links aid specifically to the financing of the infra-structure, sometimes called the social overhead, necessary for development in poor countries. Infra-structure in this context refers to such installations as ports, railways, roads, which do not produce commodities directly but promote economic activity generally. It is said that without these installations economic advance is impossible. Moreover, it is argued that the high cost puts them beyond the means of poor countries, particularly as economic return is either too long delayed, or too general or too indiscriminate for private financing. These arguments are invalid. Much of the infra-structure, even in under-developed countries, has been financed and operated by private capital. Indian Railways and Calcutta Tramways are examples. Moreover, Governments of underdeveloped countries could themselves borrow from private resources, service loans from increased revenues, which is indeed what has happened in many under-developed countries, in the comparatively recent past. Other instances can be cited to show that natural facilities such as good harbours, navigable rivers and the other facilities developed simultaneously with the expansion of economic activity and out of the revenue yielded by it.

Intra-structure of highly developed economies represents substantial capital which have absorbed much of total investments over decades or even centuries. The suggestion that a ready-made infra-structure is necessary for development ignores that infra-structure was usually developed in the course of economic advance. The suggestion represents another example of an unhistorical or unrealistic attitude to the process of development. Its literature suggests somehow that infra-structure is something like a railway and that the process of development is some thing like running a railway. You construct a permanent way, put a rail over it, then put an engine over it and it runs! But this is not how the process of economic development occurs. And also much of the literature suggests that the world was somehow created in two parts. One part was created by God with a readymade infra-structure of railways, roads, ports, pipelines and other public utilities, but somehow the Creator inadvertently forgot to provide the other part of the world with the infrastructure, which is why it has remained undeveloped or under-developed. But, of course, this is not the way it has happened. Now-a-days the problem of financing the infra-structure has been made much more difficult by various factors. They include the poor record of many underdeveloped countries in the treatment of foreign capital or the tendency of Governments to divert resources into subsidised manufactures, which reduces the funds available for the construction and maintenance of the social overhead. But these factors are rarely mentioned in the literature.

I said earlier that foreign aid is not a generally necessary nor sufficient condition for economic advance. The reason why I put in the word generally is because one can think of rare and occasional exceptions. Normally where the basic personal, social and political prerequisites of material progress are present, capital will either be generated locally or it will be available from abroad on commercial terms, either to the Government or to the private sector. But in exceptional political conditions, outside the control of the Government, this may not be so. Taiwan in the early 1950's may have presented such an exceptional case. It was then widely believed that Taiwan would shortly be taken over by the People's Republic of China. This apprehension led to a crisis of confidence, which was reversed by the flow of American aid, when no other policy was available for this purpose. The inflow of aid was also accompanied by major changes in the Government's domestic economic policy, notably, the removal of some of the more restrictive economic controls and the withdrawal of Government from direct participation in certain economic activities. And it is said that in this particular instance, American influence was partly responsible for these changes. The material progress of Taiwan since the early 1950's, has indeed been remarkable, though not more so than that of Hong Kong or Japan. It is probable that in the political conditions of Taiwan this progress would have been much slower without aid and might have even been prevented altogether. Aid to Taiwan was stopped three or four years ago.

It is also possible that foreign aid can promote the material progress of the recipients even where this is not an indispensable condition of material progress. Foreign aid increases the availability of investible funds and of know-how, where it takes the form of technical assistance. These effects may outweigh the unfavourable repercussions of its operation. But these results are likely only if the other pre-conditions of development are already substantially present. And even in these circumstances the question remains, why the capital should not be sold on commercial terms but presented in the form of external doles with economic and political disadvantages which usually accompany them. Commercial terms might be more expensive but both the capital and the technical know-how, both commercially, are likely to be much more productive than they are when supplied gratis or on subsidised terms. And except in such special circumstances as those of Taiwan which I have just noted, there is no reason why, either the Government or the Private Sector should not borrow abroad.

These arguments still leave open the question, how far the effectiveness of aid could be increased. You might say: "Well, there we are! We have the aid; we have to live with it; So, how can we make the best of it?" I think there is scope over there. There seems to be much scope for improvement in the operation of aid in several directions:

1. The criteria of allocation could be revised. Aid could be allocated much more selectively than at present and on different criteria. It could be allocated to favour Governments, which within their human, administrative and economic resources try to perform the essential and difficult tasks of Government while at the same time refraining from close control of the economy. This criterion would promote a relatively liberal economic system in the recipient countries, minimise coercion and favour material progress, especially the improvement in living standards. It would also reduce political tension in the recipient countries.

2. More thought could be given to prevent the inflow of aid from biassing the development of the recipient countries in directions based on inappropriate external prototypes. Preference could be given to Governments interested more in improving their ways and extending external contacts, rather than opening Western type Universities or erecting steel mills.

3. The flow of aid could be divorced more effectively, than it is at present, of the pressure of the commercial influence in the donor countries, for foreign aid often presents sheltered markets. You may know that part of for-

eign aid is in fact a subsidy, not from developed countries to under-developed countries but from the tax-payer in developed countries to the exporter in developed countries, because exporters obtain sheltered markets and get higher prices for their products than they would under competitive conditions.

Even if aid was reformed on these lines, which I think is highly improbable, it is still unlikely to serve as an effective instrument, let alone an indispensable instrument, for the material progress of poor countries.

The suggestion that foreign aid is necessary for the development of poor countries is the principal argument in favour of aid canvassed in the West. But there are a number of subsidiary arguments, which in popular discussion at any rate, figure as prominently — in some cases even more prominently — than the principal arguments. I shall run over some of these, rather briefly, because they are perhaps of some interest although not of major interest as the ones I have just mentioned.

One argument is that foreign aid represents the natural extension of progressive taxation from the domestic to the international sphere and that it is an instrument for the redistribution of wealth internationally. But foreign aid differs radically from domestic progressive taxation, whatever the merits of the latter. Foreign aid is paid by Governments to Governments. It is not a redistribution of income between persons and families. The flow of aid cannot be adjusted to the incomes and circumstances of persons and families. And foreign aid is necessarily partly regressive, because many tax-payers in the donor countries, who contribute to aid, are poorer than many people in the recipient countries. This is unavoidable. In practice, these partially regressive aspects of aid are made much more pronounced, because foreign aid benefits better-of people in recipient countries, like politicians, civil servants, academics and certain sections of the business community. This aspect of aid justifies the gibe that foreign aid is a system by which poor people in rich countries subsidise rich people in poor countries. Of course, in practice, the allocation of aid depends on the vagaries of political pressure and of public sentiments in the donor countries. It does not depend on any of the recognised canons of progressive taxation. In fact, the poorest communities in the under-developed world, the aborigines, the desert people and the tribal population in the interior of many under-developed countries, are not reached by aid at all.

In any case, the general case for redistributing taxation implies a basic uniformity in living conditions and requirements of income recipients. Physical and social conditions, and thus modes of living, differ enormously in the recipient countries. This difference is obvious for physical requirements but is applied also to social conditions. And the meaning and significance of income differences, and of riches and of poverty, depend greatly on social context and cannot be readily transformed between persons in widely different societies. For example, recipients of national assistance in Britain often have larger incomes than African Chiefs or smaller rulers in India, who are not normally considered poor.

Finally, the general case for redistributing taxation is far from self-evident, even on a national level, let alone on international level.

Another argument which you widely hear with reference to foreign aid is that of need. It is argued simply that the need of under-developed countries for aid is shown by their low income and is measured by it, and aid must, therefore, be given regardless of other conditions, and no questions should be asked. However, the adoption of need as an argument for aid, and as a criterion for allocations, leads to absurdities. If a country is poor or experiences payment difficulties and is in need, because the Government spends large sums on armaments or on political propaganda directed against the donors, should it be given aid? Or, if a country, or rather a Government, expels the most productive citizens, with incomes above average and thereby incomes get reduced in the country, should this serve as an argument for aid? And this is a very important practical consideration. Because, consider for example a mass expulsion of Asians from East Africa or the expulsion of Indians from Burma. In both these areas, the income of the Asians in East Africa and spefically of the Indians in Burma were above the national average, because they were the most productive groups. Therefore, the expulsion has reduced the average income. Therefore, it has increased the need. Should this be used as an argument for further aid, which would lead to further expulsion and therefore for further reduction? This shows the absurdity of adopting need as a criterion for the allocation of aid. This, of course, is quite apart from the question that the poorer groups in the under-developed countries, like the aborogines, the desert people and the like are not touched by aid at all.

An appeal for help on grounds of need should appropriately take into account the conduct of the recipients. The activities of Governments in many under-developed countries obviously and manifestly retard material progress and increase the need for aid. Again, the attitudes and values of people of many under-developed countries are inconsistent with material progress. In these conditions, aid is bound to be ineffective and irrelevant, because it does not supply the base required for material progress.

The next argument is that foreign aid is a discharge of moral duty to help the poor. But its analogy with moral obligation fails completely. Foreign aid is taxpayers' money compulsorily collected. It is thus outside the area of volition and of choice. And it, therefore, has no moral element. Indeed, contributors not only have no choice, but quite often they do not even know they are contributing. A moral obligation to help the less fortunate cannot be discharged by entities such as Governments. It can be discharged only by persons who are prepared to impoverish themselves and weaken their position, relatively to others, in order to help their poorer fellowmen. Those wishing to help under-developed countries can easily write a cheque in favour of their Governments, or missions, or schools, or hospitals operating there. For example, I am opposed to foreign aid. I still have to pay it, whether I like it or not, everytime I drink a glass of wine in England. Wine is heavily taxed and part of it goes to foreign aid. And everytime I pay income-tax, I pay some foreign aid. If I do not pay the income-tax, I go to jail. Where is the moral element?

There are also other differences between foreign aid and voluntary charity. Voluntary actions can be readily directed to the specific needs of persons and groups. It sets up possibilities of adjustment to specific requirements and circumstances, which increases the effectiveness of charity. Foreign aid, on the other hand, is distributed to Governments, not to persons or voluntary organisations. The recognition of this difference between foreign aid and voluntary charity is of much practical and of some political consequence. Of course, most people in under-developed countries do not know that their countries receive foreign aid. And those who know, usually cannot reason out the difference between foreign aid and voluntary charity. But those people who do know about foreign aid, generally and rightly, see some fundamental difference between voluntary charity and tax-payers' money compulsorily collected. And they accordingly suspect the statements that foreign aid is motivated by humanitarian sentiments.

Foreign aid is sometimes justified, specially in American discussions, on the grounds that it represents a valuable instrument of Western political strategy in keeping under-developed countries out of the Communist bloc. The argument is that somehow or other without aid these countries would become poorer and that would make the people turn to communism. This argument is in curious contrast to those based on moral and humanitarian grounds and its clear implication is exactly opposite. The argument is quite invalid. First, the argument assumes that foreign aid serves rapidly and appreciably to raise living standards, and it assumes further that an inclination to accept communism depends largely on the standard of living. Neither of these assumptions is valid. Secondly, with few exceptions, foreign aid promotes centralised and closely controlled economies. In operation, therefore, it strengthens Governments, which understandably lean towards Communist countries, whose policies they find more congenial. Thirdly, beneficiaries in these areas, as in others, are apt to resent the donors. And the transfer of taxpayer's money to foreign Governments, without control over its use, understandably arouses suspicion of sinister motives, especially of political domination. In a curious way, this suspicion is more aroused by Western aid than by Communist aid, because that aid is much more specific and much more selective and directed to certain countries which are politically and strategically important. Western aid is so indiscriminate, that it is completely baffling. Moreover, foreign aid is often regarded, in the recipient countries, as an instrument for forcing them to purchase goods, otherwise unsaleable from donor countries.

Finally, many people in recipient countries consider aid as an admission of guilt on the part of the donors as a partial restitution for past wrong. This view is held in under-developed countries, where it is widely put about that their material backwardness is a result of Western exploitation. Lastly, if foreign aid was to serve as an instrument of political strategy, you would have to align much more selectively than at present and its allocation would have to be divorced from the pressures by commercial interests in donor countries. Actually, a very striking evidence of the ineffectiveness of foreign aid, as an instrument of political strategy, was presented by the Tashkent Conference of 1966. Pakistan and India had then at least for ten years been substantial recipients of Western aid. And when they tried to have somebody to mediate for them, they did not turn to the President of America for mediation, but to the Soviet Premier.

What I have stated goes contrary to widely held views and is politically very unpopular. And, of course, it may well be that I am wrong. If it is shown that I am wrong, in the sense that the facts I presented do not correspond with empirical evidence, or that my logic is defective or internally inconsistent, I shall have to reconsider my arguments. But political popularity alone will not make me do so, because the validity of my arguments has nothing to do with their political popularity.

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ECONOMIC THINKING OF LORD KEYNES

Socialist or Capitalist ?

By

Prof. Dudley Dillard

Published : July 1968

INTRODUCTION

Deficit financing and inflation have been subjects of great interest to students of Indian economic affairs in recent years. After the recessionary conditions in some sectors of the economy have set in, there has been a controversy whether "controlled" deficit financing is necessary to stimulate those sectors and whether the overall inflationary effect of such creation of moneys on the rest of the economy could be avoided.

The name of John Maynard Keynes is generally associated with creation of money to stimulate the economy under certain conditions. There is considerable controversy on the economic thinking of Keynes. The Institute of Public Affairs in Australia, an organisation similar to the Forum of Free Enterprise, had invited Professor Dudley Dillard, well-known American economist and an authority on Keynesian economics, to contribute a paper on this subject.

We have obtained special permission from the Institute of Public Affairs to reprint this paper as a Forum of Free Enterprise booklet as we felt that it would be of great interest to students of public affairs in India at this juncture. Our grateful thanks are due to the Institute of Public Affairs for readily according us permission.

We hope that this booklet will be found useful in India.

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Preface to the Institute of Public Affairs Publication

This article was contributed to "Review", by Dudley Dillard, who was then Professor of Economics at the University of Maryland, U.S.A. Professor Dillard received the degree of Doctor of Philosophy in 1940 from the University of California for which he wrote a treatise dealing with Lord Keynes' most famous work: "The General Theory of Employment, Interest and Money". Later Professor Dillard published a book "The Economics of John Maynard Keynes" in which he attempted to clarify for the general reader the meaning and argument underlying the extremely complicated body of economic doctrine which Keynes evolved. In this difficult task he succeeded better than most writers who have attempted it. It was because of our own appreciation of the high merits of this book that we invited Professor Dillard to contribute this article dealing with the essential features of the ideas of Keynes.

Lord Keynes is the outstanding figure in economics of the 20th century. His influence, both on abstract economic theory and on practical government policy, transcends and over-shadows that of all others. The judgement of a prominent contemporary economist, Sir Roy Harrod, is no exaggeration: "Few men in history," says Harrod, "have had so great an influence as Keynes in moving the minds of men on social and economic questions."

Keynes' views have given rise to innumerable disputes. Was this pre-eminent figure a socialist? Or was he an advocate of the preservation of individual enterprise? Did he believe in detailed government planning and control? Or was his advocacy of increased government intervention limited to influencing, by broad directions, the climate in which free business enterprise is carried on?

Professor Dillard's article helps us to answer these questions and makes clear the essentials of Keynes' thought. Free from economic jargon and from difficult theoretical abstractions comprehensible only to the specialist, it is capable of being understood by the intelligent citizen interested in the central questions of modern economic and political policy. No one unable to claim some general familiarity with the work and ideas of Lord Keynes can hope to appreciate the main political and economic currents of the modern world. We are, therefore, pleased to have the opportunity of presenting Professor Dillard's article to our readers and feel that, in Australia, it will help to satisfy a long-felt and overdue need.

A popular parlour and newspaper game in the United States during 1950 has been to name the outstanding performer in various fields of activity during the first half of the twentieth century. Charlie Chaplin, for example, has received the award in motion pictures. To my knowledge, no official or semi-official judgement has been rendered in economics, but if such an award were to be made, it is safe to predict that John Maynard (Lord) Keynes would be the winner by a wide margin. In a recent scholarly volume surveying contemporary economics, Keynes' name appears more than twice as many times as that of any other economist. Keynes' most famous book, "The General Theory of Employment, Interest, and Money", published in 1936, has been the source of more discussion than any other volume in the history of economic thought in a comparable period after publication. This book already ranks along with the work of Adam Smith. David Ricardo, John Stuart Mill, Karl Marx and Alfred Marshall, as one of the greatest classics of economic literature. Keynes dominates what has come to be known as the "New Economics" in much the same manner as Einstein dominates the "New Physics."

During the past fifteen years there has arisen a new body of economic doctrine which represents nothing less than a revolution in economic thought. Although Keynes is by no means the sole contributor to this new doctrine, he stands unchallenged as its chief architect. Textbooks on the principles of economics are being rewritten to take account of the "Keynesian Revolution." The most important impact of the New Economics, however, is neither in technical economic theory nor in the classroom, but in new departures which it calls for in public policy. The great depression of the thirties and the great war of the forties precipitated the acceptance of new economic policies. Some of the better-known measures which bear the personal imprint of Keynes are the various white papers on unemployment policy, the International Monetary Fund, the International Bank for Reconstruction and Development, and, probably most important of all, new fiscal and monetary policies.

How are we to account for the pre-eminent position of Lord Keynes among his contemporaries? Personality and intellectual genius were factors. The crux of the answer lies, however, in Keynes' unique ability to combine economic analysis on a high level of abstraction with penetrating insight into practical policy. This combination of qualities has characterized great economists in the past. In the hands of Adam Smith and Ricardo the highly abstract classical economic theory was essentially an argument for a policy of *laissez faire*. The dominant position of the classical tradition, which was the ruling doctrine for more than one hundred and fifty years, now seems to have come to an end with the work of Keynes. He repudiates more effectively than anyone else the theoretical foundations of *laissez faire*. On the positive side he formulates a system of theory which demonstrates the need for positive social action in order to reconcile private interest with public welfare.

The Old Economics in Relation to the New

Although Keynes breaks with the traditional economics, he argues not so much that it is wrong as that it is irrelevant to the main problems which confront modern industrial society. The classical theory, says Keynes, is a special case which is "misleading and disastrous if we attempt to apply it to the facts of experience." In the Old Economics the presumption is that social control is not essential to the general welfare; in the New Economics the presumption is that social control is essential to the general welfare. The difference is sufficient to constitute a virtual revolution in economic theory and policy.

When Keynes wrote his General Theory in 1936, unemployment was the chief economic problem confronting capitalist nations. His main criticism of the existing body of theory was its inability to deal realistically with fluctuations in employment and national income. The attempts which had been made within the framework of existing theory came generally to the conclusion that unemployment was caused by interferences with the natural forces of free competition in the labour market. Wages were too high, and the market was not free to make the necessary adjustments, it was asserted. The existence of wage levels too high to allow full employment was plausibly explained in terms of the recent growth of strong trade unions and protective social legislation providing for minimum wages and liberal unemployment benefits. The Old Economics looked upon collective bargaining by labour and political action by governments as violations of the sacred principles of *laissez faire*. Unemployed men who tramped the streets looking for work had only themselves to blame for their unhappy plight. The solution suggested by the classical theory was simple: Since unemployment is caused by wages being too high, the remedy is lower wages. This line of reasoning could hardly have been convincing to the unemployed workers or to the general public. That the economists took it seriously, however, is clearly indicated by the work of the greatest living exponent of classical theory, Professor Pigou of Cambridge, a colleague of Keynes at King's College, who argued in his "Theory of Unemployment" (1933) that the remedy for unemployment was a general all-round reduction in wage rates.

Keynes objected strongly to this line of reasoning. He pointed to the obvious fact that millions of unemployed persons were willing to work for less than the going money wage rates, but could not find jobs at any price. The fault, according to Keynes, lay in a general deficiency of demand. A theory of unemployment must account for the deficiency of demand, and a programme for increasing employment must focus on the problem of enlarging the volume of effective demand.

Keynes' Theory of Effective Demand

In non-technical terms Keynes' theory of effective demand may be stated as follows: People are employed either in producing goods to be currently consumed (consumption) or in producing capital goods (investment). Those who are employed producing consumption goods do not spend enough of their incomes to maintain the demand for the goods they produce. They save part of their incomes. Hence the demand for consumers' goods must be supplemented by expenditures out of income derived from investment goods activity.

It we visualise consumption output as production from existing factories and investment output as construction of new factories, the essential point of Keynes' theory is that full use cannot be made of existing factories unless new factories are always being built. If no new factories were built, those previously employed in construction work would lose their jobs. These workers would have less money with which to buy the products of existing factories, causing unemployment among those previously employed in existing factories. These unemployed workers in turn would have less money to spend for the products of existing factories, and hence still more unemployment would result. Each job lost in building new factories will cause further unemployment among the workers of existing factories. Looked at in terms of re-employment, one additional worker employed in building a new factory will create additional employment in existing factories. The essential point in the theory of effective demand is that investment activity results in the disbursement of income, most of which will be spent for consumers' goods, without bringing on to the market any current consumers' goods to be sold. The expenditure of income derived from investment activity fills the gap between income received and the expenditure made out of that income for consumption goods. Another way of putting it is to say that investment is necessary as an offset to saving, which is the excess of income over what is spent for consumption.

The Role of Investment

Employment depends on the volume of effective demand, and the volume of effective demand depends on expenditure for consumption and expenditure for investment. Expenditure for consumption varies in a regular manner with changes in income, such that when income increases, consumption will increase, but by less than income. If more men are put to work, incomes will increase and expenditure for consumption may be expected to increase in a fairly regular and predictable manner. But an increase in income does not, according to Keynes' theory, bear any regular or predictable relation to investment expenditure. Because investment expenditure does not increase when income increases, there is no reason to expect that the gap between income and consumption expenditure will be filled, and, unless it is filled, the increases in employment and income cannot be sustained. When there has been no increase in investment demand (expenditure), entrepreneurs who temporarily expand output will suffer losses because the new (consumption) demand will be less than the value of the output. Entrepreneurs will be led by these losses to return to the former, and lower, level of employment and output. The significant conclusion is that employment cannot increase unless investment increases. If investment does increase, then empolyment may be expected to increase. Reduced to somewhat over-simplified terms, Keynes' theory is that employment depends on the volume of investment.

The next significant question then becomes: What determines the volume of investment? An adequate answer to this question would necessarily involve detailed technical discussion. Only the broad outlines of the analysis can be indicated here. The inability of private enterprise to provide continuous full employment arises from a failure of the demand for investment to be sufficient to fill the gap between income and consumption expenditure at full employment. How does Keynes account for the lack of sufficient investment? In advanced industrial societies most private investment takes the form of capital assets which are expected to yield a return over a period extending some years into the future. The inducement to invest depends, therefore, upon the investor's estimate of what is going to happen to his prospective investment in the future. Now the outstanding characteristic of the future, at least so far as economic life is concerned, is that we know very little about it. Estimates concerning the future are at best vague and uncertain, and can hardly be reduced to a rational, scientific basis. Estimates which are made are not as a rule held with much confidence by those who make them. There is a tendency for investors, lacking confidence in their own judgment, to rely upon the judgment of others, who likewise lack confidence in their own estimates of the future. Reliance upon the judgment of others gives some basis, a conventional basis, for action, but it does not remove the basic uncertainty. It does mean that investors tend to think alike at any one time. The resulting mass psychology finds its highest institutionalized form in the stock exchanges. When conventional beliefs turn out to be poorly founded, as they surely will in many cases, there ensures a sweeping revision of estimates and a loss of confidence. A deep pessimism enshrouds the investment market, bringing with it a sharp fall in the volume of new investment and therefore in employment.

Public Investment and Fiscal Policy

In a severe depression characterized by extreme pessimism it probably will be impossible to stimulate private investment on a scale sufficient to provide a tolerable level of employment. In the event private investment is inadequate, Keynes advocated public investment on a scale sufficient to lift the economy out of depression. The type of public investment is, generally speaking, less important than its volume, although it is naturally preferable to direct public investment toward projects of the greatest social utility. The primary purpose of whatever investment is made is to distribute income, the expenditure of which will stimulate private enterprise to produce more consumer's goods. The cumulative effect of investment upon income, described above, will tend to yield a multiple increase in national income. For example, an increase in public investment of one million pounds may result in a rise in national income of three million pounds. In this case, government investment would have distributed enough new income to cause private enterprise to increase the output of consumers' goods by two million pounds. Keynes always viewed public investment, as an aid to private enterprise and not as a substitute for it.

In order to have income-generating effects, government spending must be new spending and not merely a substitution for private expenditure. In depression, therefore, spending should be loan-financed rather than tax-financed, since it is generally valid to assume that income taken away from the public in the form of taxes would have been spent if left in private hands, whereas money borrowed, especially from banks, will normally represent a net addition to total spending. The desirability of unbalanced government budgets in times of depression now appears to be widely accepted by liberal statesmen as well as by the great majority of economists. Liberal business groups like the Committee for Economic Development in the United States seem willing to accept this type of programme. Conservative groups like the United States National Association of Manufacturers do not accept it. The extent to which public opinion has moved in the direction of the new philosophy of deficit-financing, better termed income-generating expenditures, is perhaps indicated by the mid-year economic report of President Truman in 1949, when he said it would be foolish in the face of the then increasing unemployment and falling national income to take money away from people in the form of taxes in order to balance the federal budget. The old idea that government budgets should be balanced every year is related to the *laissez faire* philosophy that government should be as inconspicuous as possible in economic affairs.

In recent years increasing stress has been placed on fiscal policy as a means for keeping the economy from falling into a depression rather than as a means for pulling the economy out of a depression. It seems fair to say that fiscal and monetary policies are the only, or at least the main defences against depression which the United States, and I think other countries could be included, has today that it did not have before 1929. How strong these defences really are no one knows because they have not yet been tested.

A minority opinion advocates interest-free financing of public investment in depression. Such a policy would enable large outlays to be made by the government without adding to the size of the interest-bearing public debt. However, this view does not appear to be gaining many new supporters, and it would involve some special difficulties in a country like the United States, where the central bank (the Federal Reserve Banks) are not owned by the government. The Keynesian idea that interest rates on securities of all types should be low has gained support among professional economists, and is understandably popular with Treasury officials.

Keynes emphasized the role of low interest rates as a means for stimulating private investment. He believed the monetary authority should have the power to push interest rates down to hitherto unprecedented low levels. Here the task is two-fold. First interest rates should be lowered, and second they should be kept down in order to convince the investing public they will remain permanently low. The second task is really part of the first because a major obstacle in lowering interest rates is the anticipation that they may rise again. This is particularly true of the long-term rate of interest. The low level of interest rates achieved in Great Britain, the United States, and other countries during the past two decades accords with Keynes' recommendations. However, Keynes' view that interest rates have a considerable influence on the volume of private investment is not generally accepted.

Inflation Policies

Keynes' policy recommendations were not confined to depression measures. He also made important contributions to the theory and policy appropriate for inflation. For inflationary situations such as usually exist in wartime, he favoured indirect monetary, and fiscal controls rather than direct controls such as price ceilings and administrative rationing. The most important of his wartime suggestions for Great Britain was a plan of forced saving or deferred pay, a plan which was partially adopted by the British Treasury during the war. Keynes argued that taxation and voluntary saving would be inadequate to finance a major war without inflation, and that therefore current consumer demand should be further curtailed by extra deductions from employees' paychecks. The income withheld during the war as an anti-inflationary measure was to be paid after the war as an anti-depression measure. In circumstances which are potentially inflationary appeals for voluntary saving as a preventive of inflation are not likely to be effective, unless the would-be savers are convinced that saving will be general. There is, however, no way to assure that saving will be participated in by all, except by making it compulsory. That is what Keynes' plan was intended to do. Keynes pointed to wartime inflation as another example where unrestrained self-interest in inconsistent with community welfare, and therefore requires social control. Furthermore, he pointed out, forced saving is consistent with the maximum freedom of individual consumer choice, in contrast with a comprehensive system of rationing and price control. The latter can work equitably only on the assumption that consumers have more or less the same tastes, an assumption which may be valid for some commodities like sugar, but cannot be valid for commodities in general. Keynes did not overlook the need for some price control and administrative rationing, but he viewed them as supplementary to fiscal policy in the fight against inflation. The versatility of Keynes' general system of theory was demonstrated by the fact that the same general framework could be used to analyse inflation and unemployment.

Wage Policy

It has already been noted that Keynes opposed attempts to remedy unemployment through cutting wages. Since employment depends on the demand for consumption plus the demand for investment, wage policy can affect employment only to the extent that it influences one or both of these sources of effective demand. Keynes did not deny that wage cuts might have some indirect tendency to increase employment. His main point was the practical one that whatever might be achieved through wage policy could be done better through monetary and fiscal policy. Keynes also rejected what may be called the trade-unionist argument that the way out of depression is to increase wage rates. In the main, he contended that higher money wages would be offset by higher prices and would leave real wages and real effective demand about as they were before the wage rise. A survey of professional opinion would, I think, reveal that Keynes' views concerning wage policy are now generally accepted by economists. The pre-General Theory notion of the classical economists that unemployment can be remedied by cutting wages is certainly no longer accepted by economists or public policy makers. In present-day discussions of wage policy, stress is placed on the need for short-run stability of money wages and prices, with flexibility introduced through monetary and fiscal measures.

The foregoing discussion of wages refers to the short run in which productivity of labour is assumed not to change. In the longer run, increases in productivity permit real wages to increase. An increase in real wages may come about either in the form of higher money wages with constant prices, or in the form of constant money wages with lower prices. Of these two alternatives, Keynes preferred the former.

Keynes on Socialism and Capitalism

The question is sometimes asked whether or not Keynes was a socialist. Clearly he was not a socialist at least in any generally accepted meaning of that term. His efforts at reform were directed toward the preservation of capitalism and economic individualism. In policies Keynes was an outspoken member of the Liberal Party, and disliked the philosophies of both the Labour and Conservative Parties. He believed government ownership of the means of production to be both unnecessary and undesirable. Keynes was quite hostile to Marx and Marxism. He referred to Marx's Capital as "an obsolete textbook which I know to be not only scientifically erroneous but without interest or application to the modern world." On the occasion of a visit to the Soviet Union in 1925 Keynes was impressed, on the one hand, with the economic inefficiency of Communism and, on the other hand, by the strength of Communism as a type of religious faith.

Equality of wealth and income is a fundamental tenet of socialism. Keynes believed there was social and psychological justification for significant inequalities of wealth and income, but not for such large disparities as exist in capitalist society. His theory of employment led him to the conclusion that greater equality would contribute to the maintenance of higher levels of employment and to a more rapid growth of capital. People with low incomes tend to spend for consumption a larger proportion of their income than do people with high incomes. Therefore a redistribution of income from high to low income groups would increase the community's propensity to consume, which in turn would increase employment and national income. Out of the enlarged national income the community would save and invest more than before. The larger investment represents a greater accumulation of capital. This argument reverses the traditional or classical economics, which justified inequality of income and wealth as a necessary condition of progress on the ground that most saving and investing is done by the wealthy out of their surplus income. This classical argument like much else in classical economics would be valid under conditions of full employment, but it is not valid if one assumes, as Keynes did, that the characteristic condition of capitalism is one of less than full employment.

Keynes also believed that the wealthier a capitalist community becomes, regardless of the degree of inequality, the more difficult it is to maintain a satisfactory level of employment. He says: "Moreover the richer the community, the wider will tend to be the gap between its actual and its potential production; and therefore the more obvious and outrageous the defects of the economic system." A poor community will have little difficulty employing all its resources because it will tend to spend on consumption a large proportion of its total incomes. Only a small gap needs to be filled by investment. A wealthy community, on the other hand, will have great difficulty maintaining full employment because the gap between income and consumption will be large. Its investment outlets must be great if there are to be enough jobs for all. The very fact that the community is rich in accumulated capital assets weakens the inducement to invest because every new investment must compete with an already large supply of old investments. This version of the paradox of poverty in the midst of potential plenty is strikingly similar to the socialist view that capitalism is characterized in its historical development by a growing discrepancy between its capacity to produce and its capacity to consume. Karl Marx thought that the increasing productivity characteristic of large-scale technology would lead to depressions and wars of increasing intensity until finally capitalism would collapse. There is no historical evidence to support this view, and whatever one may think of it or of the evidence, it is one of the fundamental premises which leads Communist nations to anticipate certain victory in the struggle for power against capitalism. In socialist theory, at least in Marx's version of it, the ultimate determining forces of history are economic rather than military or political.

There are, however, important differences between Keynes and Marx. Keynes attributed the contradictions associated with the deficiency of effective demand to *laissez faire* capitalism and not to capitalism as such. In the long run he believed the answer to the capitalist dilemma lay in the elimination of capitalism's worst faults rather than in the elimination of private ownership of the means of production. Capitalism's special faults are associated with its monetary and financial institutions, with speculation, and with rentierism. Keynes' general position can best be characterized as that of a critic of financial capitalism and a defender of industrial capitalism. Acceptance of the positive measures advocated by him would mean the end of *laissez faire* capitalism, but would preserve the advantages of private enterprise and economic individualism. Keynes believed that the worst enemies of capitalism were those who, refusing to admit its faults, were unwilling to do what was necessary to save it.

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India's Prosperity is Linked with Progress of Private Sector

A LETTER BY

EUGENE BLACK

Chairman, World Bank

TO

T. T. KRISHNAMACHARI

Finance Minister, India.

The Bank has now an opportunity of considering the report of the economic mission led by Mr. Thomas McKittrick which visited India earlier this year at the invitation of your Government and I am writing to inform you of the general conclusions which we have reached.

We in the Bank have great admiration for solid achievements in the economic field which have been recorded in India during the past five years.

We have also been impressed with the broad outlines of development programme which your Government is proposing to follow during the next five-year period.

At the same time, there are certain aspects of the programme and of your plans for its execution which in the Bank's view should give India cause for concern.

On these I am sure you would wish me to state our views frankly.

In saying this, I have in mind the generally sympathetic reception which your Government has given to the observations on the economic programme and policies in India which our mission communicated to Mr. Deshmukh on June 30 and we welcome the fact that you have made these observations public in India.

In making my own comments, I should like first to emphasize once again my conviction that India's interests lie in giving private enterprise, both Indian and foreign, every encouragement to make its maximum contribution to the development of economy, particularly in the industrial field. While I recognise that the Government itself must play an important role in India's economic development, I have the distinct impression that potentialities of private enterprise are commonly underestimated in India and that its operations are subjected to unnecessary restrictions there.

Above all, in the country which is short of capital and with limited resources of managerial and administrative talent, it is important that respective roles of public and private enterprise should be fixed entirely on the basis which will ensure the most effective contribution of each to the economic development and not any theoretical concept of role that each should play. I see the tendency towards this latter approach in your industrial policy resolution of last April which reserves to the State exclusive responsibility for new undertakings in large number of industries including oil, coal and other minerals.

It seems to me that the policy rigidly applied could only result in imposing heavy additional burdens on the already overstrained financial and administrative resources of the public sector in restricting the rate of development in these vitally important fields.

The Bank has carefully studied the mission's findings with regard to the Second Five-Year Plan and it shares the Mission's conviction that in so far as the public sector is concerned the programme is too large to be completed within five years.

Quite apart from possible financial limitations, it seems inevitable in the light of past experience in India and elsewhere that the execution of projects will be delayed by administrative difficulties and by lack of trained managerial and technical personnel with experience of large-scale construction and industrial operations.

This makes it all the more important that every effort should be made to secure technical co-operation and financial support of foreign private enterprise in carrying out the development programme.

The bank welcomes arrangements that have been made to associate foreign firms with construction and operation of major undertakings both in the public and private sector but hopes that more positive measures will be taken to facilitate foreign investment that consideration will be given to suggestions made by the mission in its memorandum.

The Bank has been impressed with the record of financial stability maintained in India over the past five years and with skill displayed in the management of public finance.

At times when the rate of development is accelerating rapidly, I am sure that financial and monetary authorities will continue to realise the importance of keeping a close watch over financial balance and to take prompt action to curb inflammatory rise in aggregate demand which, if allowed to proceed unchecked, could easily jeopardise the success of the whole development programme.

There is danger that the amount of deficit finance proposed in the Second Five-Year Plan will prove to be well beyond the capacity of Indian economy to absorb without excessive price increases and the Bank would, therefore, urge upon the Government the need to keep a careful and continuous check on development expenditure in the light of financial resources currently available to meet them.

With regard to external finance, the Bank feels that greater emphasis should be laid in the Second Five-Year Plan on measures to develop overseas earnings.

The demand for imports of industrial material, petroleum and other producers' goods must be expected to grow as industrialisation proceeds and concurrent expansion of exports will be essential if dependence on foreign aid and borrowing is to be progressively reduced.

Determined effort is, therefore, called for to strengthen competitive power of India's traditional export industries, particularly tea, jute and cotton textiles and to build up new exports both manufactured and primary products.

In some instances, for example, cotton textiles and vegetable oils, Government policies appear at present to have effect in actively discouraging exports and the Bank hopes that the Indian Government will be ready to reconsider these policies in view of the severe pressure on foreign exchange resources which is likely to persist throughout the coming period of intensive development in India.

It is indication of the Bank's sincere interest in the success of India's development programme and in improvement of the material well-being of the Indian people.

We are anxious to play our full part in assisting India to achieve satisfactory rate of economic growth.

The Bank believes that Indian economy has capacity to develop basic strength which would justify considerable increase in overseas borrowing during the next five years.

It is scarcely possible, however, for the Bank to commit itself to any specific figure for lending.

We feel that we will have to consider the pace and scale of our further loan operations in India from time to time in the light of economic conditions and prospects taking into consideration, the economic policies which are pursued by your Government.

On the one hand, we should have to take into account the extent and character of impact on India's balance of payments of services of external debt contracted from sources other than the Bank.

On the other hand, our disposition to lend would be favourably influenced by the amount of external financial assistance which India obtains without incurring the fixed foreign exchange obligations.

I hope that we may contemplate development of close co-operative relationship between your Government and Bank in which, from time to time, we shall mutually review the progress being made in execution of the Second-Five Year Plan and consider together further the role which the Bank may be able to play.

For the present, I should like to assure you that the Bank is ready to embark forthwith on consideration and analysis of such further investment projects as your Government may desire to put forward.

The problem of transport is one which has particularly engaged the attention of the Bank as well as of your own Government and of private interests throughout India.

We are struck by the extent to which lack of adequate transportation facilities threatens to constitute the bottleneck in the country's economic development.

We recognise that substantial resources are already allocated for investment in Railways under the Second Five-Year Plan and we are not necessarily suggesting increase in this allocation.

Indeed, in view of the acute shortage of capital for development and very high import content of Railway investment, attention should be given first to the possibilities of improving operational efficiency of Railways and of encouraging road transport and coastal shipping; the latter between them should be capable of making considerably larger contribution than at present.

I think that transportation could appropriately be regarded as top priority for any Bank financing that may be devoted to the Second Five-Year Plan.

As preliminary detailed examination of projects in this field, I suggest that it would be useful if the general problem of transport in India could first be discussed between your Government and the Bank in the light of study of Indian Railways which, I understand, has recently been carried out at your invitation by a team of American railway consultants.