Why India won't bow to 'Super 301'

The U.S. government seeks to get Delhi to abandon American system-modeled economic policies. By Ramtanu Maitra.

On May 25, India, along with Japan and Brazil, was targeted by the U.S. government for "unfair trade practices" under the "Super 301" section of the U.S. Omnibus Trade Act. "India's web of market access barriers is a serious and long-standing impediment to U.S. exports," intones the U.S. Trade Representative's report backing up the action. India was cited in particular, according to U.S. government press releases, for its "trade-related investment measures"—namely the conditions India places on foreign investment—and its "insurance market practices" (the insurance business is nationalized in India).

Despite an eleventh-hour junket to India by U.S. officials in early May, and a series of patronizing statements from U.S. Ambassador John Hubbard following the naming of India, the Indian government has categorically rejected the U.S. order to negotiate or face retaliation. In a press conference in Lucknow May 27, Indian Finance Minister S.B. Chavan said the U.S. demand for a change in India's policy on insurance amounted to direct interference in the country's domestic policy matters. "It is not for them to decide the Indian policy matters," he said, adding that every sovereign nation had a right to formulate and follow the policies it deemed appropriate. "I fail to understand the provocation," Chavan stated.

Indeed, there is a most profound irony in the U.S. "free trade" move. It is not merely that the United States, as Indian Commerce Minister Dinesh Singh pointed out, maintains its own restrictive regime, or that the unilateral move undercuts the multilateral GATT process to which the United States is otherwise nominally committed. The fact is that the policy of "protection" that independent India adopted to shape its sovereign economic development is a leaf out of the "American System" textbook, the school of political economy developed by Friedrich List in Germany, and Mathew and Henry Carey in the young United States, to ensure nation building in the face of the "free trade" depredations of the imperialism of the day. The same policy of "protection"—in force through at least the Lincoln administration—made America the economic powerhouse it became.

Why India?

Today, though, in the U.S. action we are witness to a nation that has forgotten where it came from. Thanks to the free marketeers and the money experts who have come to rule the roost on Wall Street and in Washington, the United States has been transformed from a net creditor nation to the most highly indebted nation in the world. Its annual trade deficit, in spite of some belated protectionist measures, runs about $130 billion in the red, and that, too, in a good year. U.S. Special Trade Representative (USTR) Carla Hills is rightly concerned about it. But out of this $130 billion net trade deficit, India's share of the loot earned through "unfair trade practices" amounts to some $670 million—a tiny 0.5% contribution to U.S. trade agonies!

But that is hardly the point. Ambassador Hubbard, in a speech in Calcutta following India's placement on the hit-list, was rather candid in his own patronizing way. Indeed, one finds that behind the "free market" litany and the easy broadsides—*everyone knows* that India has "the most protected markets in the world, where high tariffs, confusing licensing regulations, and out-and-out prohibitions make it much more difficult to do business than in most other countries," as Mr. Hubbard put it—there are some very specific plums to be picked.

"Why was India named?" Hubbard asked rhetorically. "I often have heard the argument that India should not be named because it accounts for such a small fraction of U.S. trade (and of the U.S. trade deficit). *Let me point out, however, that the potential of the Indian market is enormous.*" Translation: *We could really make a killing, if only the Indian government would stop being so unfair as to impose foreign equity limits, domestic content requirements, and export performance requirements.*

One has only to read through the text of the USTR report on India to have an image of the U.S. government playing agent for a gang of rogues who have just confirmed the sighting of a camp of virgins on a distant island. There we find the following official objections to India's basic economic policies raised under the section, *Investment Barriers*:

> Foreign investment is usually permitted only in so-called "core sectors," consisting of some 30 officially designated industries. Investment outside these sectors is prohibited unless production is predominantly for export. . . .
>
> Various government agencies closely screen for-

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eign investment. . . .

When screening foreign investments, India considers many factors. These include the extent the project fits national planning goals, incorporates advanced technology, leads to exports or import substitution, and uses local materials and equipment.

In general, local financing is not available to foreign investors. Financing must come from foreign exchange earnings generated by exports or from foreign sources. . . .

Foreign investors generally cannot hold more than 40% equity. Majority foreign equity may be allowed if the firm is export-oriented, incorporates desired technology, or is otherwise considered vital to India's national interests.

And so on.

Another section of the report complains that since India's more than $3 billion annual domestic insurance market is government-owned, foreign insurance giants have only marginal access.

These are the priority targets, among a long list of alleged "illegalities" which must be abandoned or significantly altered if India wishes to avoid economic retaliation from the United States.

TABLE 1

Per capita output comparison between Britain and India at the time of independence

Item	Britain	India	India's output as percent of Britain's
Electric energy (Kwh)	1,095	13.1	1.2
Pig iron (kg)	189	4.0	2.1
Steel (kg)	302	3.6	1.2
Finished steel (kg)	238	2.4	1.1
Coal (kg)	4,251	85.5	2.0
Cement (kg)	174	4.4	2.5
Cotton fabrics (meter)	35	14.5	41.4

Source: G.K. Shirokov, *The Industrialization of India*, 1973.

Behind the policy of protection

A glance at the background to India's policy of protection helps put the issue into perspective. That India does have a protective system of tariffs, licensing, foreign exchange, and investment regulation that was set up to promote the sovereign development of the nation's industry and agriculture following independence from British colonial rule in 1947 is well known. What is not generally appreciated is that the policy has worked more or less well over the years and, though diluted significantly over the last decade, remains the backbone on which the Indian economy and the 800 million souls it supports, stands.

At the time the British were thrown out of the subcontinent, India had no industry worth mentioning. **Table 1** gives some indication of the level of industrial backwardness into which India had been pushed under British rule. Following independence the single biggest problem Indian leaders faced was how to mobilize financial resources sufficient to allow India to lay the foundations of its basic industries. Since India was not a colonial power like Britain, which had plundered the resources of poor nations for centuries under the guise of "civilizing the barbarians," the options before the late Prime Minister Jawaharlal Nehru and his planners were narrow.

With the population close to 400 million, and half of them pauperized by British looting, large-scale export of raw materials and natural resources to earn foreign exchange was rejected out of hand. It was recognized that India had neither the technology necessary to produce quality goods that could fetch premium prices in foreign exchange from abroad, nor enough capital to develop all sectors of the economy simultaneously. Basic and heavy industries had to be built up on a priority basis to utilize the resources in India, and make them available to the people and for infrastructural development, it was determined. India would have to import capital goods, at the expense of scarce foreign exchange, to build basic heavy industry and its own capital goods sector. The idea of exporting capital goods was at that time a distant dream.

Indian industrialists at the time were weak and their capability to invest minuscule, in relation to the nation's requirements. The amount of capital necessary for generating more electrical power, building more roads and railroads, developing skilled manpower, and so on, for the establishment of basic industries was far beyond the private entrepreneurs.

Ultimately, the decision to develop the country through building up primary industries (machine tools and other capital goods), a functional infrastructure, and establishment of institutions which would provide the manpower needed to run the industries, necessitated adoption of a series of policies which would lead to capital formation for a continuation of the nation-building process—a policy of "protection."

The measures taken

Following the formulation of the Second Five Year Plan (1957-61), when the thrust was directed toward the development of capital goods industries, a series of measures were undertaken to make the plans viable. They were the: a) industrial licensing policy; b) import-export policy; c) administered price policy; and, d) foreign investment policy. Through the Industrial Policy Resolution of 1956 the government put various industries into different categories—first,

those that were the exclusive responsibility of the government; second, those which could be established by government and private entrepreneurs; and, lastly, all others, which, it was assumed, would be developed mostly though not exclusively in the private sector. Industries in the first group (called "List A"), which were selected both for their strategic and capital intensive nature, included railways, atomic energy, defense, and air transport.

Industrial licensing measures were adopted to channel the limited available capital from large industrial houses (which had a vise-like grip on the banks, owning several outright) into development of smaller entrepreneurs. This was conceived not only as a means to develop new businesses but also to break the monopoly of the large business houses, many of whom were primarily traders serving the British Raj. Under the industrial licensing provisions, any enterprise which wishes to manufacture a new item or substantially expanding existing capacity must obtain a license from the relevant governmental authority.

Trade and tariff protection was provided through the import-export policy. A whole gamut of items was listed as "prohibited" under this measure to protect nascent industries brought into existence through the industrial licensing measures. Since the technology available then in India was hardly comparable to that in the West, new Indian entrepreneurs could match neither the quality nor the production cost of the same goods made abroad. The import-export measures also governed the allocation of imported raw materials and components. Some relaxation—in the form of import quotas and tariff cuts which amounted to subsidies—was, however, provided to manufacturers in a position to export their products.

Administered pricing policies were extended to those products deemed crucial or essential, including such basic items as steel, aluminum, cement, etc.

As far as foreign investment was concerned, to protect local industries the government decided to keep the multinationals out wherever Indian industry had developed indigenous capabilities. As in other areas, the specific conditions and regulations governing foreign investment have always been determined by the requirements of the overall development strategy. Priority is given to those foreign investment projects which will help boost the production potential of the economy as a whole. Conversely, projects involving consumer goods that are aimed at "cashing in" on India's large and protected domestic market are not allowed.

Taken as a whole, these measures were directed toward channeling the nation's scant resources for maximum economic effect. For example, the industrial licensing measure was used to prevent the manufacture of goods considered non-essential. The policy not only helped in "saving" capital, but also in channeling it into the small-scale industries and, to a more limited extent, agriculture. The export-import policy helped to preserve foreign exchange necessary for importing equipment and capital goods to carry out the industrial development program outlined in the five year plans. Nationalized insurance and the 1969 nationalization of the 14 major private banks were also essential steps to boost the government's capability to mobilize resources internally for the development tasks.

These systematic steps—including India's famed 20% savings rate—helped to keep the country's foreign debt low, and otherwise protected the nation's elementary sovereignty. Unlike most developing nations, India depends on foreign aid and foreign funds generally for only a fraction—albeit a critical margin—of its developmental budget.

The baby and the bathwater

There is no doubt that the measures were absolutely necessary for laying the foundation of the basic industries and upgrading infrastructure. Opening up the economy in the 1950s, as Milton Friedman and others demanded at the time—and as today's financial overlords routinely demand of developing nations whose industrial capability resembles that of 1947 India—would have dealt a severe blow to the nation. The result would certainly have been perpetuation of the looting policy which the British had successfully carried out for the better part of 200 years.

None of this is to say that the protective measures worked as well as expected, or that significant distortions have not in fact crept in. A classic example of the distortions has been drawn out by G.K. Shirokov, a Soviet economist, in his book on India's industrialization. The encouragement given to the comparatively smaller undertakings, he points out, was often interpreted as a "struggle against monopolistic tendencies," and in setting up the small enterprises, ideological zeal tended to overpower economic considerations such as economies of scale. A large number of small enterprises, particularly in the textile sector, were set up which were destined to have a very high cost of production per unit of finished product. Then, to protect these small entrepreneurs, prices of finished products were set to cover their uneconomical cost of production—and the larger, more efficient units run by the "monopolists" raked in the windfall.

The late Dr. R.K. Hazari, an Indian economist and former central bank governor, showed in a 1966 study how the licensing process, which was designed to weaken the large industrialists' monopoly through competition, was actually having the opposite effect. A favorite game involved licenses for new enterprises or for expansion. After securing such a license, the large industrialist liked to sit on it. Keeping the supply of products below effective demand assured continued profits from higher prices in the non-official market and kept competitors at bay as well.

The licensing measures in particular gave birth to a host of illegalities carried out through a huge bureaucracy. The measures were used by unscrupulous businessmen and bureaucrats who conspired to create miles and miles of red tape to frustrate honest entrepreneurs. The entire government came

to be known as the "license and permit Raj"—a caricature of the original policy of protection that is today more often than not mistaken for the real thing.

The economic records

Desite these side-effects—which could have been prevented with a bit of vision and determination, and which are in fact being tackled in some measure today—the core of the approach remains sound. Indeed, the policy of protection has succeeded significantly in facilitating the development of India's industrial sector. A market survey of products available will show this, as does the qualitative shift in India's export content over the last three decades. While in the early 1960s less than 40% of India's total exports consisted of manufactured goods, the figure in 1988-89 is close to 70%. During the same period, India's exports have grown more than 15 times in current rupee value.

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A measure of the modernization that has been achieved is the keen interest that foreign investors are showing of late. This had begun before the Beijing Massacre, and it is expected that foreign investors—Carla Hills notwithstanding—will invest more and more into India in the immediate period ahead. In 1988-89, foreign investment doubled from the year earlier.

The fact is, that the economic policy parameters established by Nehru and his team are responsible for bringing India to the point today where its "great potential" is recognized around the world. India is among the top producers in the world not only of traditional items like two-wheeler scooters and motorcycles, polished gems, and jewelry or textiles. There is a strong industrial base in metallurgical, chemical, petrochemical, and engineering industries. India has also developed significant capacities in engineering design and computer software.

The country has a massive railway network, the second largest in the world, an extensive telecommunications system which is now undergoing a major overhaul for complete modernization, a string of major power generating facilities producing more than 60,000 MW daily, and a huge fertilizer industry to meet the needs of India's agriculture.

The country's basic economic policy has also given India the independence to develop its nuclear power sector—a vital element for economic growth in the coming century; to become self-sufficient in food and most other agro-products; and to build up an advanced space-related industry which in the near future will play a crucial role in India's security.

More important, the problems that Indian planners faced in the 1950s with respect to a weak private sector have eased considerably. Today, Indian industrialists are showing maturity. A number of them have developed the capability to invest in industries which require almost a billion dollars to set up. This strength also shows through in the capital market, which for years could mobilize no more than about $100 million, but which leaped to $3.5 billion 1988-89. (Admittedly, lopsided current exchange rates, which hurt every developing nation, including India, take some of the glow off these achievements, but they are nonetheless real despite that.)

No time to 'open up'

At the same time, these developments within the Indian economy should not give rise to the illusion that the measures of yesteryear ought to be torn up today. Technologically, India is still far behind the developed nations. India's industries are less productive and they waste raw materials. Measures are still very much needed to protect those industries which are essential, and upgrade their technological level. The small-scale sector—the number-two employment provided after agriculture—has remained financially crippled and technologically deprived. Protection must be provided while building up this sector's technology base and productivity. Giving foreign investors free run of this sector today would be to place the fox right outside the chicken coop.

The recent so-called liberalization steps taken by the government also call for caution. Undertaken to facilitate the modernization and technical upgrading of industry, the new policy is highlighted by the liberalization of imports, and emphasis on expanded exports, and the deregulation of most industries. In the short term, this policy tack can create serious problems arising out of foreign exchange shortages.

Finally, India's Eighth Five Year Plan is on the anvil, and if the draft paper is an indicator, the government will have to mobilize more than $400 billion to push the plan through. This size capital requirement can only be generated internally—not more than 6% in fact will come from foreign sources. To generate such a huge amount of developmental resources, over and above government's current expenditure, India must continue to tap its own small savers, as well as financial institutions such as the insurance companies and banks, the capital markets, and rely on tariff measures as well.