

Cato Institute Policy Analysis No. 170: Foreign Aid and India: Financing the Leviathan State

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Executive Summary

With a debate now raging over whether further foreign aid programs financed by U.S. taxpayers are justified in the post-Cold War era, a review of the development experience of the recipient of the largest amount of foreign aid is instructive. India has received more foreign aid than any other developing nation since the end of World War II--estimated at almost \$55 billion since the beginning of its First Five-Year Plan in 1951.[1] It has long been an article of faith among development economists and policymakers that foreign aid is a necessary and central component of economic development, yet the record of Indian economic development since 1947 belies that view.

India has had one of the lowest rates of growth of all developing countries and remains one of the poorest countries in the world after almost 45 years of aid-financed, centrally planned development. Foreign aid has directly financed and sustained India's centralized planning and control framework and thereby financed the growth of one of the noncommunist world's largest and most inefficient public sectors. In 1988-89, 101 of the country's 222 largest public-sector companies recorded losses and contributed to a federal deficit five times as large, in relative terms, as the U.S. budget deficit.[2]

Today, after nearly 45 years of planned economic development, India's annual per capita income remains around \$300. Almost 40 percent of Indians live below the official poverty line, and the absolute number of Indians in that category increased sharply between the late 1950s and the mid-1980s. In short, India is a paradigmatic case of the failure of government-sponsored aid; it stands as a dramatic testimonial to why such aid should go the way of the socialist development model it has bankrolled for decades.

A Brief Anatomy of India's Economic Failure

The centrally planned industrialization strategy of India's post-independence period has resulted in over 60 percent of investment in the industrial sector going into public-sector enterprises. The private sector has been severely restricted by the banning of private-sector investment in major industries; a strict regime of industrial licensing; intrusive quantitative, price, and distribution controls; uneconomic preferences for cottage, village, and other small industries; extensive labor-market and employment controls; and comprehensive external-sector controls.[3] Restrictions have included prohibitive tariffs, perhaps the developing world's most comprehensive and onerous set of quantitative controls and restrictions, an ever-expanding export control and subsidization scheme, and severe and often prohibitive restrictions on both direct and portfolio foreign investment.[4]

Over 20 million Indians are on the public payroll, and around 70 percent of all formal, above-ground employment is in the public sector. Confiscatory tax rates combined with a jungle of red tape--permission to open a hotel involves 45

applications and over 25 different government agencies--have led to the growth of one of the largest and most thriving underground economies in the world, where an estimated 50 percent of economic activity is generated.[5]

From 1950 to 1985 per capita income in India grew at a meager average annual rate of 1.5 percent, compared with rates of 5.5 to 6.5 percent in the "newly industrializing countries" of Hong Kong, South Korea, Singapore, and Taiwan and 3 to 4 percent in the three southeast Asian nations of Indonesia, Malaysia, and Thailand.

India's heavily centralized economic planning, its lack of openness to trade and investment, and its large accumulated inflow of foreign aid--mainly in the form of official development assistance--have set it apart from its neighbors.

Foreign Aid and the Support of Soviet-Style Planning in India

The interaction between a country's economic performance and official foreign economic assistance (hereafter referred to as foreign aid, in contrast to other voluntary, private foreign assistance) is difficult to isolate. Attempts to investigate the impact of foreign aid on economic development using statistical techniques have been inconclusive, although the statistical evidence seems to indicate on balance that aid has had little or negative impact on development indicators such as savings, investment, and the growth of national income.[6] It is clear, however, that the majority of so-called developing nations that have received large amounts of foreign aid have failed to develop.

The history of official foreign aid to India is a classic example of the failure of foreign aid and its systematic facilitation of pervasive central planning. Foreign aid assumed a dominant role in India when a centrally directed heavy industrialization and "self-reliant" import-substitution strategy was adopted at the beginning of the Second Five-Year Plan in 1956-57. The plan's chief architects, Professor P. C. Mahalanobis and Prime Minister Nehru, patterned their socialist framework explicitly after the Soviet heavy-industry planning model. Nehru, India's prime minister for the first 17 years after independence, was heavily influenced by the ideals associated with the Bolshevik Revolution. In his 1936 presidential address to the Congress party, Nehru said that there was

no way of ending the poverty, the vast unemployment, the degradation, and the subjection of the Indian people except through socialism [and] the ending of private property, except in a restricted sense, and the replacement of the private profit system by a higher ideal of cooperative service.[7]

The underlying vision of Nehru and his associates that has molded India's economic policy since independence is further illustrated in his comments to a prominent Indian journalist in 1960:

We have accepted the socialist and cooperative approach . . . the planned and scientific approach to economic development in preference to the individual enterprise of the old laissez faire school. . . . Planning and development have become a sort of mathematical problem which may be worked out scientifically. . . . It is extraordinary how both Soviet and American experts agree on this. If a Russian planner comes here, studies our projects and advises us, it is really extraordinary how his conclusions are in agreement with those of, say, an American expert. . . . The moment the scientist or technologist comes to the scene, be he Russian or American, the conclusions are the same for the simple reason that planning and development today are almost a matter of mathematics.[8]

U.S. Aid Officially Promotes Comprehensive Planning

Indeed, in the 1960s India began to be heralded in the West as the epitome of rational, planned economic development. John P. Lewis, the dean of American foreign aid experts who had held prominent posts with the Council of Economic Advisers, the UN Reconstruction Agency, and the U.S. Agency for International Development's mission to India, argued in his influential 1962 book, *Quiet Crisis in India*:

There is much less need now for [a] defense of the very concept of comprehensive economic planning in countries like India. . . . Today [such] planning is officially viewed as an essential concomitant of any national development that merits American assistance, and the United States government is urging such planning upon Latin American, African, and Asian governments that do not yet practice it.[9]

Lewis argued that India's planned development was the most feasible and desirable path for a country at an early juncture in the development process and that the decentralized market system was inappropriate, destined to fail, and had only led to the development of Great Britain and the United States because of "special circumstances." His book made an impassioned plea for vastly stepped up levels of American aid to support the "rationally planned economic development" of India's Second Five-Year Plan.

World Bank Requires Comprehensive Planning

Multilateral aid agencies such as the World Bank espoused a similar vision in their lending policies from the 1950s onward. The World Bank's Fifth Annual Report (1949-50) noted,

The Bank would prefer to . . . base its financing on a national development program, provided that it is properly worked out in terms of projects by which the objectives of the program are to be attained.[10]

In the succeeding decades, the preference for national development programs made countries such as India, Tanzania, Indonesia, Ethiopia, and Mexico--which pursued centrally directed economic development plans--favored recipients of World Bank aid. But India received the most World Bank aid; it received an accumulated net amount of well over \$20 billion in historical-year dollars (much less than if measured in current dollars) from 1951 through 1989. Most of that \$20 billion went to public-sector projects.

Although India has not become a communist or completely socialist country--its governments have always tolerated a substantial "private sector," which actively collaborates with the government to sustain monopolies and control the growth of competitors--India's comprehensive economic planning has been actively supported and reinforced by donor countries, international agencies, and the very nature of the aid-granting process. By requiring governments to undertake comprehensive development planning as a precondition for receiving foreign aid, donor nations and agencies actively abet the socialization of the developing world.

American Aid Feeds Appetite for Public-Sector Imports

Before the heavy-industry-oriented Second Five-Year Plan, India had normally run a current account surplus and had built up substantial reserves of foreign exchange. By 1960-61, at the end of the second plan, the current account deficit had grown to around 2 percent of net national product; it was around 4 percent in 1970-71. Over the same period, foreign exchange reserves declined by almost 95 percent from their 1950-51 level, in spite of huge infusions of foreign aid.

India ran a large current account deficit throughout the 1970s and 1980s. Private remittances from abroad, especially from the Middle East and Europe as a result of increased labor migration to supply labor shortages in the newly rich members of the Organization of Oil Exporting Countries, and the government decision to allow nonresident Indians to open interest-bearing foreign exchange accounts prevented the situation from being worse.

It is important to note that throughout that period the account balance on private accounts was generally positive (with the exception of a few years), which meant that the current account deficits were due solely to the steeply rising imports of the government sector and the stagnation of exports from that sector. Given the decline in foreign exchange reserves, the prohibitive restraints on foreign investment, and the stagnation of exports, the high level of official government-sector imports sustained from about 1960 through the mid-1970s was made possible only by large capital inflows in the form of foreign aid. Those aid-financed imports were both largely ineffectual in increasing the rate of growth and responsible for bloating the inefficient public sector. To the extent that those large inflows of foreign aid were a painless substitute for the foreign exchange that would otherwise have had to have been earned through exports, such aid had a major displacing and retarding effect on economic growth. India was able to achieve a higher rate of unproductive, public-sector investment than it would have been possible to maintain in the absence of foreign aid.

Thus, throughout the post-independence period, the public sector consistently "dissaved," while the private sector and the rest of the world provided the savings needed to finance the ever-growing public sector. Through the mid-1970s foreign aid remained the primary source of funds for growth of the public sector; such aid accounted for well over 50

percent of the government deficit during the second plan. To the extent that it displaced private savings, foreign aid retarded self-financing growth. In the late 1960s the lack of domestic savings was cited as one of the reasons for nationalization of the major Indian commercial banks. Foreign aid thus provided major support for the substantial socialization of the Indian economy.

American Aid Underwrites Government Enterprises

The United States has been the single largest donor of foreign aid in the world since World War II. Through 1983 Washington gave away almost \$321 billion (in historical-year dollars) in overseas assistance, concessional loans, military aid, and humanitarian assistance.[11] The United States was the single largest donor to India in the postwar period.

The bulk of American aid to India was disbursed from 1955 to 1971, when the Indian economy was being nationalized and heavy-industry-focused national economic planning was being institutionalized. As a result, most of the American aid went to the Indian public sector. (Less than 5 percent of U.S. aid went to India's private sector between 1951 and 1985.) Washington's aid to the Indian public sector was used to finance government fertilizer and industrial plants, large-scale irrigation projects, state-owned power and rural electrification projects, dairy development, highway construction, locomotives and rolling stock for the government-owned railway system, airplanes for the state-owned international airline, agricultural extension and the establishment of agricultural universities, and technical assistance and equipment for large state-owned institutions of higher education. Another significant component of American aid to India was food aid. Food aid, under the Food for Peace Program (Public Law 480), was given directly to the Indian government, which channeled the food through its public distribution system.

American aid to the public sector actively fostered the growth of that sector at the expense of the private sector. Leonard Tansky concluded in a 1967 book that

such aid has increased the resources of the public sector relative to the private sector and has enabled the government to pursue policies which have tended to restrict the activities of private investment and have tended to discourage a larger inflow of foreign capital.[12]

Many of the projects that received American aid had low or negative rates of return, particularly the many fertilizer plants and electrical power projects that have always operated at a financial loss. In the agricultural sector, where a large portion of U.S. aid was directed, restrictions on prices and production, compulsory government procurement schemes, a ban on private wholesale trade in grain, and an inefficient public distribution network skewed the incentives of both suppliers and consumers of agricultural products. A ban on futures trading and speculation further hobbled the workings of private markets. The result was perpetual shortages and rationing during most of the post-independence period and widespread food shortages during the 1960s. All the while, Washington continued to funnel American aid and "agricultural know-how" to the Indian government without requiring the removal of those distortions.

American Food Aid Discouraged Local Production

American food aid under P.L. 480 is a classic example of good intentions gone awry and the pernicious nature of foreign aid. Before the heavy-industry-oriented second plan, food production in India had been growing steadily and very little food had been imported to augment domestic production (except during 1951-52).[13] Foodgrain prices had been quite stable before 1956.

The demand for food imports increased sharply, and for good reason, with the advent of the second plan. Since the Indian government channeled the majority of U.S. aid--as well as the majority of aid from all foreign government sources--into public-sector (and some private-sector) industrial projects, a systematic capital starvation of agriculture occurred. The rate of net capital formation in farming fell below the rate of population growth, while the government's industrialization plans induced the migration of farm labor to urban areas. By the mid-1950s, as food shortages began to develop and foreign exchange reserves fell sharply, the Indian government entered into an agreement with the U.S. government for assistance for the import of foodgrains under P.L. 480. Later, India would become the recipient of the most aid under that program; India received 50 million tons, or nearly 40 percent of all foodgrains and 25 percent of all commodities given by the U.S. government under P.L. 480 from 1955 through 1971.[14]

Although tracing the economic effects of P.L. 480 food imports is a complex task, a number of serious negative effects have been identified.[15] One major result was the repression of the domestic price of wheat and other commodities that were imported under the program. Farmers reacted to the lower prices and reduced the acreage planted in both wheat and competing cereals. In fact, the large and escalating shipments of P.L. 480 food aid between 1955 and 1965 bankrupted large numbers of Indian farmers. And that happened when India was a predominantly agricultural country with a significant proportion of uncultivated arable land and vast potential for expansion of food production, as was demonstrated by India's yield per acre being one of the lowest in the world.

Another negative effect stemmed from the fact that, under P.L. 480, the Indian government appeared to receive the U.S. foodgrains free and it could garner substantial rupee receipts upon resale of the grain in Indian markets. Funds raised by the Indian government from the resale of such food aid accounted for 56 percent of the external assistance to India's public development outlays during the 1960s.[16] In short, the Indian government had a direct interest in maximizing the quantity of P.L. 480 imports and sales in order to raise funds to finance its public development schemes.

U.S. Food Aid as Inflation Machine

Although it repressed relative prices in the agricultural sector, P.L. 480 food aid had a substantial net inflationary effect on the Indian economy.[17] New money was created as a result of the peculiarities of P.L. 480 financial procedures. The majority of P.L. 480 food shipments to India were executed in exchange for Indian rupee funds, which were to be accumulated in Indian banks and used to cover local U.S. government expenses (with the balance to be returned to the Indian government in the form of concessional loans and grants).

To make payments into the local U.S. government account, the Indian central bank in effect issued securities redeemable on demand to that U.S. account. Subsequent disbursements from the U.S. account (for loans or grants to the government of India, loans to private firms under a special U.S. program, or local U.S. government uses) were made by a "liquidizing" process whereby the special securities were first converted into Indian public debt; that debt was then purchased by the central bank and finally passed on to the U.S. account as newly created money. The U.S. account, in turn, disbursed that money to the Indian public sector as loans and grants. One prominent scholar of the Indian economy, B. R. Shenoy, has estimated that deficit financing (the use of newly created moneys to finance budget disbursements) due to P.L. 480 operations accounted for as much as 35 percent of total deficit financing from 1962 through 1971 and increased the inflation rate by 9.8 percent a year.[18]

"Green Revolution": No Counterbalancing Force

Western government aid to India is often applauded for the central role it has played in financing research on high-yielding varieties (HYVs) of cereals, particularly wheat, which ushered in India's so-called Green Revolution of the 1960s. It is estimated that without HYVs, Indian cereal output would have been about 15 to 20 percent less than it was during the late 1960s and the 1970s. HYV research was supported in large part by Western aid to international centers under the auspices of the Consultative Group for International Agricultural Research, to which the United States was a significant donor

Nevertheless, the development and introduction of HYVs accounted for less than 2 percent of the foreign aid that India received during those years. Any effect HYVs may have had on Indian yields and output merely reveals the potential of small investments in private agriculture. However, it is not universally agreed that the Green Revolution had any real impact on Indian agricultural development. For example, a number of studies have revealed that in spite of impressive gains in wheat yields and output since 1967, the overall rate of growth of agricultural output did not accelerate after the Green Revolution.[19] Thus, even in the agricultural sector the effects of foreign aid are ambiguous at best.

Banking on the Poor: The World Bank and India

As noted earlier, India has received more World Bank aid than any other developing country in the postwar period. In fact, India has been the World Bank's star patient and almost the *raison d'être* of its burgeoning growth--if one is to believe the following statement by the bank's semiofficial historians, Edward Mason and Robert E. Asher.

No country has been studied more by the World Bank than India. . . . India has influenced the Bank as much as the Bank has India. . . . This applies particularly to the Bank's conception of the development process--the role of government in the process [and] the need for grants, soft loans, and program assistance. . . . In the eyes of the Bank's management, India (because of its obvious needs and limited creditworthiness) offered the clearest justification for the creation [in 1961] of [the International Development Association] as its soft-loan affiliate [which makes zero-interest loans with 50-year maturities]; without IDA, the Bank could not have continued to be heavily involved with India.[20]

Indeed, India and the World Bank formed a lasting partnership that promoted centrally directed and coordinated nonmarket decisionmaking in the Third World. According to one commentator, that partnership made the World Bank "responsible for the rush to socialism in the Third World." [21]

The relationship between the World Bank and India illustrates all the characteristics of the foreign aid process that are emphasized by critics of such aid: a preference for national development plans, a bias toward large projects and unsuitable external models, greater government control over the economy, imposition of price and other economic controls, and the politicization of economic life.[22] That is clear in the following observation by Mason and Asher.

The Bank conceived of its task as seeing that India's five-year plans got support, especially since India's needs for investment in infrastructure (railways, electric power, irrigation) matched the Bank's availabilities and expertise.[23]

India received its first World Bank loan on August 18, 1949, for development of the government-owned Indian Railways. That loan was followed by one for agricultural machinery for a large public-sector reclamation project and for the first stage of a large central government multipurpose project. With the establishment in 1960 of its "soft-loan," affiliate, the IDA, the bank began lending to India on highly concessional terms (zero interest and 50-year maturities--terms that in effect made those loans grants). The World Bank's commitments to India expanded rapidly thereafter.

The majority of the funds received by India from the World Bank "group," which includes three lending affiliates, has gone into the public sector. Government corporations that have been directly aided by World Bank funds include firms in the power, coal-mining, irrigation, oil, petrochemical, telecommunications, fertilizer, steel, mass transit, railway, airline, and cement sectors. Returns on concessional World Bank loans to projects in the power, coal-mining, fertilizer, steel, mass transit, railway, and cement sectors have been dismal; returns in the other industrial sectors have been positive only because of the nature of the product and the pricing policies of those industries (for example, oil and petrochemicals). The World Bank's continuing largesse to the Indian public sector is evidenced by the fact that currently some \$16 billion in aid committed by the bank remains unused because the requisite rupee "matching funds" cannot be found either by the central government or by the state governments.

The effect of World Bank lending on one Indian town was described by the chairman of a private company there in a 1991 letter to Hoover Institution scholar Judy Shelton. That explicit testimonial is worth quoting at length.

[In response to] your comments on foreign aid on the CNN Crossfire show . . . I would like to give you the following information on how the World Bank has ruined India by giving loans. In fact, it has given loans to bring structural change in the negative direction of going from [the] private sector to [the] public sector.

This town, Madurai had an excellent network of private busses giving efficient, good and punctual service. It was taken over by the government with [a] World Bank loan. Now we have nationalized transport which is continuously running in loss and giving extremely poor service. When the public sector company runs in loss, the World Bank insists on [an] increase in the fares until they get 15 percent return on investment as a condition for them to get [a] further loan. Then the public sector companies increase the fares. In reality, more than 15 percent return on investment could be obtained from these companies even after reducing the fares by 10 percent, if only the rampant corruption and inefficiency is removed.

The whole state of Tamilnadu had several private busses running profitably and efficiently and they were all nationalized with World Bank loans and all the state-run transport corporations are running in loss. . . . Interestingly, the World Bank loans [were] used only to take over busses from [the] private sector and not to add new services where [the] private sector was not operating. In the same way, the World Bank is giving loans to [the government's] inefficient Railways, Telecomm system, etc. which can be run more efficiently by the private sector.

The World Bank has given [a] loan to this Madurai town to improve the water supply. Within a month the money was used by the politicians to sink 100 borewells of which 50 percent of the amount went as [a] bribe. After a couple of years the World Bank once again gave [a] loan to improve the water facility. Once again, another 100 borewells were sunk right next to the old 100 borewells which were not in use. The same thing was repeated again. The corrupt politicians always use the World Bank loan since they can take up any project, whether they are required or not, just to get bribes from the project. They need not raise the tax to meet the project expense. The loan has to be repaid only by future taxes by which time these rascals won't be there.[24]

A substantial part of the World Bank's (as well as the U.S. Agency for International Development's) concessional loans to India has gone for state projects in irrigation, area development, infrastructure development, dairy development, rural and urban drinking water supply, population and nutrition, and agricultural extension and training. The effectiveness of the loans to infrastructural, agricultural, and tertiary-sector projects can be judged by examining the World Bank Operations Evaluation Department's review of the bank's experience with rural development projects from 1965 through 1986. According to that internal review:

The most conspicuous project failures were in the large group of area development projects. . . . The audits to date of half of the area development projects judged them to have failed. . . . That form of area development project that came to be known as "integrated rural development" [performed] so poorly as to raise questions about the utility of that approach in many situations.[25]

Although a majority of those failed area development projects were in sub-Saharan Africa, the World Bank also provided aid to a number of large area development--especially "integrated rural development"--projects in India.

Drowning in Aid--World Bank Loans for Public Irrigation

The major portion of the World Bank's lending to India for rural development has been for state-run irrigation projects. From 1971 through 1989 the bank provided concessional credits totaling some \$3.8 billion to large-scale public irrigation projects in India. Worldwide, the bank currently devotes about 25 to 30 percent of its total lending program for agriculture to such projects, yet the real costs and returns of such projects have been widely criticized. One assessment, by Robert Repetto, sums up the problems this way:

Public irrigation is heavily subsidized in the Third World as well as in the United States, and has become an enormous fiscal drain. Revenues collected from farmers in most countries cover barely 10 to 20 percent of the costs of building and operating the systems--less in many countries than the costs of operation and maintenance alone. . . . Neither farm beneficiaries, irrigation agencies, nor international banks are financially at risk for the success of irrigation investment, and so pressures for new capacity lead to a proliferation of projects, many of dubious worth. Benefit- cost analysis of such long-term investments is inherently speculative, and easily becomes overly optimistic when the political pressures of the pork barrel come into play.[26]

Public-sector irrigation systems everywhere are typically plagued with cost and time overruns, endemic inefficiency, chronic excess demands, and widespread corruption and rent seeking. In India, government functionaries and system operators--who control the allocation of water supplies--routinely extort high rents from farmers. In spite of the web of problems associated with public irrigation systems, the World Bank continues to bankroll those wasteful projects in India and in many other nations. By 1986 large-and medium-sized surface water public irrigation schemes supplied about 40 percent of India's total irrigated acreage. The balance--60 percent--was supplied mainly by private (but heavily subsidized) ground water irrigation and minor local surface irrigation schemes. The Indian Planning Commission itself has admitted:

In spite of large investments made in the irrigation sector and the phenomenal growth during the past 30 years, the returns from the investment, both in terms of yield as well as finance, are very disappointing. [And] the states are losing more than rupees 427 crores [1 crore = 10 million] per year on these irrigation projects.[27]

The huge amounts of World Bank aid to the irrigation sector in India led to a proliferation of projects far beyond the implementation capability of the government or the absorptive capacity of that sector. Despite the dismal performance of Indian irrigation and the large inefficiencies and wastage involved, loan-maximization pressures at the bank and burgeoning demand on the part of Indian planners and administrators led to a cornucopia of lending that threatened to drown the Indian masses in corruption, rent seeking, and displacement costs.

Private Irrigation Puts World Bank-Supported Projects to Shame

Private irrigation has a good track record of efficiently providing farmers with water, which translates into higher private returns. Even though private tubewell irrigation costs more than public irrigation, farmers are willing to pay the higher prices because of the higher returns they can get by using a reliable and noncapricious private source of irrigation. According to a U.S. Agency for International Development study on irrigation systems in India:

Farmers in some areas with water control provided by private irrigation are willing to pay 6 to 9 times the water charges levied for [state-run] canal supplies. Millions of private tubewells, some equipped with piped distribution systems serving graded fields, are evidence of this.[28]

The greater efficiency of private tubewells is reflected in higher agricultural production, income, and crop ping intensity.[29] In fact, farmers in public irrigation "command areas" fail to invest as much in land leveling, field channels, and crop configurations as do farmers who are served by private or communal irrigation systems. As a result, output of foodgrains per hectare averages only 2 to 3 tons on canal-irrigated land; it averages 5 to 6 tons per hectare on land irrigated by private tubewells.[30]

By 1985 the proliferation of new public irrigation projects--while existing ones in the process of completion, modernization, or rehabilitation were suffering gross time delays and cost overruns--led the Indian government to take the unprecedented and drastic action of proscribing all new starts during the Seventh Five-Year Plan (1985-90). In fact, at the end of the Sixth Five-Year Plan, 150 major and 400 medium-sized irrigation projects with an estimated cost to completion of more than \$10 billion remained unfinished. The World Bank attributed the problem largely to the proliferation of projects under construction, as [Indian] state governments succumbed to pressures to take up new projects whenever possible.[31]

According to a brief prepared by the Environmental Defense Fund:

[India's] large-scale irrigation projects have a poor record. In 1986, out of 246 large-scale irrigation projects that were started since 1951, 181 were still incomplete. In a speech in 1986 to state irrigation ministers concerning large-scale irrigation projects started after 1970, then Prime Minister Rajiv Gandhi stated "perhaps we can safely say that almost no benefit has come to the people. . . . For 16 years we have poured money out. The people have got nothing back, no irrigation, no increase in production, no help in their daily life." [32]

World Bank's Deadly Narmada Dam Project

Despite the impressive record of failure of public irrigation projects in India, the World Bank approved more than \$1.2 billion in new irrigation credits for New Delhi between 1985 and 1990, including \$150 million (of a total credit of \$450 million) for the Narmada dam and river valley project. That dam project--budgeted at \$3.2 billion--is the single largest project of any type undertaken in India since independence. The threat of environmental damage, flooding of valuable agricultural and forest lands, destruction of critical ecosystems, and displacement of thousands of tribal and other communities has made the Narmada project (especially the component called the Sardar Sarovar project) one of the most hotly debated World Bank (and Indian) projects of all time. It is estimated that the project will flood around 1,000 square kilometers of forest and other land, destroy around 35,000 hectares of the country's meager forest cover, and displace over 2 million people. An Indian government study has estimated that the dam will sharply increase the

incidence of cholera, malaria, encephalitis, and other waterborne diseases.

The project was first conceived in 1946, and the foundation stone was laid by Prime Minister Nehru in the early 1960s. Ever since, the project has been mired in controversy over the displacement of thousands of tribal people and farmers; the extent and distribution of benefits; and, more recently, the impact on the environment. The dam site has been the venue of demonstrations by hundreds of thousands of people.

Already, \$0.95 billion has been spent, and work on the project proceeds apace; but costs are likely to double to \$6.4 billion, and the project is expected to be delayed inordinately. Pressure is being brought to bear on the World Bank to suspend aid to the project, but continued financing seems secure.

The Environmental Defense Fund has estimated that the Sardar Sarovar part of the Narmada project alone will lead to the submersion of around 14,000 hectares of valuable forest land and around 11,500 hectares of fertile agricultural land and forcibly displace more than 100,000 tribal and rural people.[33] In spite of a World Bank policy on involuntary resettlement, which requires that a resettlement plan be established before a project is approved, no comprehensive resettlement plan has been established for the Sardar Sarovar project; even the number of people to be displaced has not been determined. One World Bank-financed project in Singrauli, India, has subjected 200,000 to 300,000 of the rural poor to forced relocation two or three times, and in some cases even four or five times, over the past 25 years (each time with little or no compensation).[34] One specialist at the Environmental Defense Fund has summed up the situation succinctly.

The gap between the World Bank's stated goals and reality on the ground is growing. . . . The World Bank, rather than consistently aiding in alleviating Third World poverty, in reality has contributed to the marginalization and devastation of hundreds of thousands of tribal and indigenous people and rural poor in India, Indonesia, and Brazil. . . . Worldwide, out of approximately 56 projects that the World Bank is financing involving resettlement, the Bank cannot document one single case where the population that has been resettled is better off than before or has reached the standard of living which they had before.[35]

The International Monetary Fund: India's Perennial "Temporary" Reprieve

India was one of the first recipients of an emergency International Monetary Fund loan, after the fund's founding in 1944, and (except for short periods of time) it has been on one or another IMF program ever since--that is, for more than four and a half decades. Several times in the 1970s India received short-term loans from the IMF for balance-of-payments support. Its biggest borrowing from the IMF was negotiated in 1980, when the combination of the oil shock of 1979 and a disastrous harvest led India to seek a \$5.8 billion loan under the IMF's relatively new "Extended Fund Facility." The loan's early repayment, due to a set of fortunate circumstances, caused India to be heralded as a developing nation that had matured and transcended the vicissitudes of uneven development. The fortunate circumstances included a string of good harvests, increasing remittances from Indians working in the Middle East, a surge of exports after the global recovery from the U.S.-led recession of 1981-83, and the tapping of the international credit market--then flush with recycled petrodollars--by Indian public- and private-sector companies.

During the mid and late 1980s, India borrowed extensively abroad--commercial borrowing as well as concessionary loans from such agencies as the World Bank--to finance its growing budget deficits. (In 1986 officials of India's central bank reported that new foreign commercial borrowing during the nation's seventh plan would total about \$8.8 billion--in contrast, they noted, to the \$20 billion in new commercial loans that the World Bank was "pressuring" India to accept during that period.)[36] By 1991 the consolidated budget deficit of the central and state governments totaled over 10 percent of India's gross domestic product, and India's total foreign debt reached \$70 billion that year.

The major portion of the government's fiscal deficit is due to its inability to check the growth of spending on expanding public-sector employment, expenditures on subsidies, interest payments on government debt, and other non-productive expenditures. The government's annual borrowing to finance its own consumption rose 55-fold from 1981-82 through 1989-90. The figure reached approximately \$10 billion in 1991.

In early January 1991 foreign exchange reserves fell to the equivalent of the value of two weeks of imports, and India came close to defaulting on its commercial borrowing, as well as on loans from the World Bank and the IMF. In late

January the IMF hurriedly approved a \$1.8 billion loan for India, which staved off the impending default. That initial loan was followed in October 1991 by another IMF loan of \$2.3 billion. The terms of that loan committed India to negotiate a further structural adjustment loan of from \$5 billion to \$7 billion with the IMF.

In February 1991 a political crisis ensued when Prime Minister Chandrashekhar resigned under considerable pressure from Rajiv Gandhi's Congress party. Chandrashekhar's resignation left his government a caretaker government because new elections would not take place until May. In March a financial crisis developed as India's hard currency reserves fell to \$2.1 billion--less than the value of six weeks of imports--and \$1.5 billion in payments to the multilateral financial institutions was due at the end of March. India's central bank responded by initiating a classic IMF "austerity" contraction: it devalued the rupee to boost exports and imposed severe credit restrictions on imports.[37] To do the latter, the central bank substantially raised--to 133 percent--the cash deposit that importers of raw materials, components, and capital goods are required to pay before opening letters of credit. The aim was to cut India's imports in succeeding months by 10 to 15 percent by making them prohibitively expensive.[38] The objectives were to attempt a "quick fix" of the external payments crisis, please the IMF with whom India was negotiating for another emergency loan, and make the nation appear more creditworthy.

Ten months later, in January 1992, the government released figures that showed that India's trade deficit had declined sharply to \$1.34 billion between April and September 1991 (compared with \$3.04 billion in the same period of the previous year). But behind that seeming improvement lies another picture: imports fell by 17.5 percent, but exports also fell--by 6 percent. The export falloff is chiefly the result of the import restrictions, which have made raw materials, components, and capital goods scarce. Some Indian economists are saying that the economy is in the grip of an import-cut-induced recession.[39]

As those new trade figures reveal, no amount of cosmetic manipulation of the economy in the name of "austerity" or "necessary devaluation" can help as long as the microeconomic and institutional fundamentals are not drastically altered. Without enforceable private property rights, the establishment of the rule of law, across-the-board scrapping of all internal and external regulations, dismantlement of the public sector, and restoration of a voluntary exchange market economy, any efforts to solve the crisis will produce mislabeled "successes" such as trade deficit reductions in the midst of a policy-induced recession.

The IMF's focus on balance-of-payments difficulties ignores the fundamental institutional and microeconomic factors that underlie the current Indian crisis. As long as the funds obtained through the IMF, the World Bank, and other external assistance programs continue to be channeled into the resuscitation of India's moribund public sector, such crises will recur. The continued allocation of funds to unproductive public-sector undertakings will only cause the budgetary and external deficits to grow, the external debt to balloon, and the foreign exchange crisis to persist.

The Rest of the Aid Cabal

From 1960 through 1985 aid from the Aid India Consortium--comprising the United States, 13 other countries with developed market economies, and certain multilateral aid institutions such as the World Bank--accounted for 85 to 90 percent of total aid to India. The United States donated 50 percent of the total in 1961-62; in 1988-89 the World Bank donated 65 percent of the total, and the U.S. share had declined to 1 percent--less than the Soviet share. The changing proportions clearly indicate that, when it comes to bankrolling Indian socialism, the World Bank is filling the shoes vacated by the United States.

The other members of the consortium also made significant contributions to the socialization of the Indian economy. The British provided aid to build a large steel plant, a paper mill, a heavy electrical machinery plant, and a fertilizer plant--all in the public sector. The West German government aided another government steel plant and public-sector area development programs in the agricultural sector. The Japanese provided aid for large public-sector fertilizer and iron ore projects and agricultural extension programs. Switzerland, Denmark, Holland, New Zealand, and Australia provided aid for dairy development, animal husbandry, and the processing of animal products. Norway and Sweden primarily aided the forestry and fisheries industries. Most of those funds were channeled through the public sector (although in a few cases the ultimate beneficiaries were in the private sector).

The Soviet Union and Eastern Europe never contributed more than 8 to 10 percent of the total aid received by India,

but the role played by those countries, especially the Soviet Union, in shaping India's development strategy was significant. Soviet and Eastern bloc aid went predominantly into supporting public-sector heavy industry, such as steel, heavy machine building, coal-mining machinery, heavy electrical equipment, oil refineries, thermal power stations, antibiotics, and surgical instruments. The participation of those countries in the metals and minerals sectors was also significant; they provided aid, machinery, and technical assistance.

Since about 80 percent of the cumulative investment in public-sector manufacturing enterprises in the postwar period was in four major industrial sectors--metals and minerals, steel, chemicals and pharmaceuticals, and petroleum-- the influence of Soviet and other Eastern bloc aid on the growth of public-sector enterprises was disproportionately large. Thus, both the Western and the Eastern bloc nations directly collaborated in the diminution of the role of the private sector in the Indian economy and the increased hold of the government over the private lives of the citizens of India. Given that the return on that public-sector investment was low or negative, foreign aid from those countries contributed directly to the impoverishment of the Indian masses.

Dismantling the Public Sector: A Project Still on Hold

When he was elected in May 1991 Prime Minister Narasimha Rao promised to "restructure . . . privatize . . . and reduce the overmanning" of India's public-sector industries. Yet by November 1991 he appeared to already be following the path of his predecessor, Rajiv Gandhi, who also promised such reforms but left the Indian government more bloated and bureaucratic than ever. In a major speech in New Delhi in November, Rao ruled out as "premature" any privatization of India's 250 state-owned industrial companies or its state-owned banks.[40] India's economic rebirth remains on hold.

In 1980-81 the top 157 of India's 250 public-sector companies (including the always profitable oil companies but excluding companies that by virtue of large cumulative losses had negative total capital employed) sustained an overall loss of over \$160 million on a total capital employed of around \$20 billion.[41] In 1984-85 India's public-sector companies (except oil) sustained a similar overall loss of around \$160 million; the most disastrously unprofitable concerns were the coal-mining and textile corporations. By 1984-85 the public-sector National Textile Corporation, set up in 1974, had accumulated losses of \$480 million, which were all absorbed by the central government. By 1989-90 the accumulated losses had risen to \$860 million, compared with that year's turnover of \$685 million.[42]

India's state-government-owned electricity boards (SEBs), which were and remain large recipients of foreign aid (mainly from the United States and the World Bank), have been some of the most unprofitable undertakings in the Indian public sector. The cumulative losses of 17 SEBs in March 1990 stood at \$186 million.[43] State road transport undertakings are also highly inefficient and overstaffed; they accumulated losses of over \$625 million from 1985 through 1990.[44] Yet they continue to be the recipients of foreign aid from a number of countries and multilateral institutions.

Thus, the Indian public sector has been a black hole-- sucking in huge amounts of foreign taxpayers' money and sinking it into inefficient, loss-producing public-sector enterprises and projects. Such aid represents a huge transfer of potentially productive financial resources to unproductive uses, which seriously diminishes the rates of economic growth and the growth of income in both the donor nations and India.

Conclusion

Except for a few cases of alleged foreign aid success-- such as critical food relief when millions were on the verge of starvation in the early 1950s and again during the mid-1960s--foreign aid to India has been an unmitigated disaster. It has acted as both a catalyst and an encouragement for the politicization of the Indian economy. It has supported central planning and facilitated the growth of the public sector at the expense of the private sector and the establishment of a private-property-oriented market system. It has also encouraged corruption, rent seeking, and graft in the Indian economy. Foreign aid has been--and continues to be--predicated on an outdated and false theory of development economics that assumes that only capital and access to technology are needed for economic development.

The Sardar Sarovar dam project epitomizes the manner in which World Bank aid enables socialist governments to undertake massive projects of dubious economic value and inflict high costs on the very people they are ostensibly

meant to benefit--creating, instead, millions of "development refugees."

No amount of future foreign aid will provide the means for India to break the vise of its current underdevelopment. Fundamental changes in policy are required to restore a market order that functions well. Needed changes include

- * Dismantlement of the overbearing central planning system;
- * Wholesale privatization of the huge and inefficient public sector;
- * Across-the-board scrapping of all domestic, trade, and external-sector controls and regulations; and
- * Restoration of absolute rights to private property and voluntary exchange.

Recent half-hearted moves towards liberalization will just not suffice, although they have shown the potential for growth that freeing the economy will bring. Indian policymakers need not fear the consequences of such a change in policy, since they will be journeying down a well-traveled and successful path. The wealth of the Western nations and the countries of east and southeast Asia attests to the merit of following that path. The United States, other Western nations, and the multilateral aid institutions should begin to wean India and their other clients from the drug of foreign aid. Those donors' largesse has actively encouraged the impoverishment of nations. It is time to stop.

Notes

[1] It is difficult, if not impossible, to get accurate totals of foreign aid when the number of donor countries and agencies and aid currencies exceeds 30. Data were compiled from various issues of the government of India's Economic Survey. (The \$55 billion aggregate figure is historical year, not current-year, dollars.)

[2] Steve Coll, "Budget Axe Endangers India's Socialist Icons: Massive Bureaucracy under Attack," Washington Post, February 26, 1991, p. A-16.

[3] Jagdish Bhagwati and Padma Desai, *India: Planning for Industrialization* (New Delhi: Oxford University Press, 1970) remains the classical reference on industrial planning (and plan implementation difficulties and failures) in India.

[4] See Jagdish Bhagwati and T. N. Srinivasan, *Foreign Trade Regimes and Economic Development: India* (New York: NBER and Columbia University Press, 1975).

[5] See Poonam Gupta and Sanjeev Gupta, "Estimates of the Unreported Economy in India," *Economic and Political Weekly*, January 16, 1982, pp. 69-75.

[6] See, for example: Keith Griffin and J. L. Enos, "Foreign Assistance: Objectives and Consequences," *Economic Development and Cultural Change* 18 (April 1970): 313-17; V. Bornschieer, C. Chase-Dunn, and R. Rubinson, "Cross-national Evidence on the Effects of Foreign Investment and Aid on Economic Growth and Inequality: A Survey of Findings and a Reanalysis," *American Journal of Sociology* 84, no. 3 (November 1978): 651-83; Paul Mosley, "Aid, Savings and Growth Revisited," *Oxford Bulletin of Economics and Statistics* 42 (May 1980): 79-85; and Donald Snyder, "Foreign Aid and Domestic Savings: A Spurious Correlation," *Economic Development and Cultural Change* 39, no. 1 (September 1990): 175-81. The most comprehensive and detailed study of foreign aid emphasizing its negative impact is Paul Mosley, *Foreign Aid: Its Defense and Reform* (Lexington: University of Kentucky Press, 1987).

[7] Cited in V. B. Singh, ed., *Nehru on Socialism* (New Delhi: Government of India Publications Division, 1977), p. 67.

[8] *Ibid*, pp. 50-51.

[9] John P. Lewis, *Quiet Crisis in India* (Washington: Brookings Institution, 1962), p. 115. Emphasis added.

[10] World Bank, *Fifth Annual Report (1949-50)* (Washington: World Bank, 1950), p. 8.

- [11] See Doug Bandow, *U.S. Aid to the Developing World: A Free Market Agenda* (Washington: Heritage Foundation, 1985), p. ix.
- [12] Leonard Tansky, *U.S. and U.S.S.R. Aid to Developing Countries* (New York: Praeger, 1967), p. 113.
- [13] In 1951 Congress passed the India Emergency Food Aid Act to provide for a low-interest loan of \$189.7 million for the import of 2 million tons of wheat from the United States.
- [14] B. R. Shenoy, P.L. 480 Aid and India's Food Problem (New Delhi: Affiliated East-West Press, 1974), pp. 3-8.
- [15] *Ibid.* The analysis that follows relies heavily on Shenoy.
- [16] Paul Isenman and H. W. Singer, "Food Aid: Disincentive Effects and Their Policy Implications," *Economic Development and Cultural Change* 25 (January 1977): 235-36.
- [17] See Shenoy, chapter three, for a detailed discussion.
- [18] *Ibid.*, pp. 86-93.
- [19] See, for example, U. N. Srinivasan, "Trends in Agriculture in India, 1949-50 to 1977-78," *Economic and Political Weekly*, Annual Number, August 1979; and P. K. Bardhan, *The Political Economy of Development in India* (New Delhi: Oxford University Press, 1984), p. 11.
- [20] Edward Mason and Robert E. Asher, *The World Bank since Bretton Woods* (Washington: Brookings Institution, 1973), pp. 675, 681-82.
- [21] James Bovard, "The World Bank vs. the World's Poor," *Cato Institute Policy Analysis* no. 92, September 28, 1987, p. 1.
- [22] See, for example, Peter T. Bauer, *Reality and Rhetoric: Studies in the Economics of Development* (Cambridge, Mass.: Harvard University Press, 1984), p. 46.
- [23] Mason and Asher, p. 682.
- [24] Letter of August 21, 1991, to Judy Shelton from the chairman and managing director of a private company in Thenur, Madurai, India; the Cato Institute is holding the author's name in confidence in consideration of the political and economic climate in which he must continue to operate.
- [25] World Bank, Operations Evaluation Department, "World Bank Experience with Rural Development, 1965-1986," *Internal Report*, 1987, p. viii.
- [26] Robert Repetto, "Skimming the Water: Rent-Seeking and the Performance of Public Sector Irrigation Systems," *World Resources Institute Research Report* no. 4, December 1986, p. 1. The remainder of this section relies heavily on Repetto.
- [27] Quoted in N. D. Jayal, "Emerging Pattern of the Crisis in Water Conservation," in *Indian Environment: Crises and Responses*, ed. J. Bandyopadhyay et al. (Dehra Dun: Natraj, 1985), p. 86.
- [28] U.S. Agency for International Development, "Irrigation Development Options and Investment Strategies for the 1980s: India," *Water Management Synthesis Project Report* no. 6, July 1981; quoted in Repetto, p. 7.
- [29] J. Thakur and P. Kumar, "A Comparative Study of Different Irrigation Systems in Western Uttar Pradesh," *Indian Journal of Agricultural Economics*; summarized in Repetto.
- [30] B. S. Dhawan, "Irrigation's Impact on the Farm Economy," *Economic and Political Weekly*, September 28, 1985,

pp. 124- 28.

[31] Leslie Abbie et al., "Economic Returns to Irrigation Investments in India," World Bank Staff Working Paper; cited in Repetto, p. 4.

[32] Environmental Defense Fund, "Environmental, Social and Economic Concerns Related to the World Bank Financed Sardar Sarovar Dam and Power Project, and Sardar Sarovar Water Delivery and Drainage Project," Memorandum to Barber Conable, president of the World Bank, March 1991, p. 3.

[33] Environmental Defense Fund, p. 1.

[34] Statement of Bruce Rich during Hearing on Environmental Performance of the Multilateral Development Banks Before the House Subcommittee on International Development Institutions and Finance, April 8, 1987; cited in Bovard, p. 6.

[35] Statement of Lori Udall on Behalf of the Environmental Defense Fund Concerning the Social Impact of Forced Resettlement in World Bank Financed Development Projects Before the Congressional Human Rights Caucus, September 27, 1989, p. 4. Emphasis in original.

[36] Narendra Reddy, "India to Scale Down Borrowing," Indian Express, October 14, 1986, p. 1.

[37] K. K. Sharma, "India Places Severe Import Credit Limits," Financial Times, March 22, 1991, p. 20.

[38] David Housego, "India Seeks Emergency Funding to Stave Off Payments Default," Financial Times, March 26, 1991, p. 1.

[39] K. K. Sharma "Big Fall in India's Trade Deficit," Financial Times, January 15, 1992, p. 4.

[40] David Housego, "Poll Victory Makes Rao More Cautious Than Ever," Financial Times, November 21, 1991, p. 7.

[41] Hannan Ezekiel, ed., Corporate Sector in India (New Delhi: Vikas, 1984), Table 7.2.

[42] India Today, October 15, 1990, p. 64.

[43] India Today, September 30, 1990, p. 67.

[44] Ibid.