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CENTER DISCUSSION PAPER NO. 67

THE INTERNATIONAL DEVELOPMENT OF INDIA
AND PAKISTAN

Benjamin I. Cohen

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The International Development of India and Pakistan¹

Benjamin I. Cohen

Yale University

"We recognize no legitimate demand on the student to spare anybody's feelings. Facts should be stated coldly: understatements, as well as overstatements, represent biases."*

*Gunnar Myrdal, Asian Drama, p. 23.

This paper attempts to review briefly what other economists have already written about the international trade of India and of Pakistan, to raise some questions which may suggest further empirical work, and to make some assertions for which I cannot now cite any reference. Section I briefly discusses the import policies of India and Pakistan. Section II examines the exports of India and Pakistan to the rest of the world, and Section III deals with the benefits to each country of increased trade between them.² I ignore the international movement of people and of capital.

¹Paper prepared for International Economic Association Conference on Economic Development in South Asia (Kandy, Ceylon: June 1969). Research assistance was provided by Jim Dubin. I have benefitted from comments by several colleagues at the Economic Growth Center. Any errors and all opinions are solely my responsibility.

²A few readers may wonder about changes in the terms of trade. Based on data in International Financial Statistics, India's terms of trade improved slightly between 1950 and 1967, as her index of export prices rose by 73 percent and her index of import prices rose by 67 percent. Using 1954-55 as a base, Pakistan's terms of trade improved by 10 percent through 1960-

I

Through most of the period since 1967, both India and Pakistan have belonged to that large group of developing countries that have included "import substitution" as an important element of their strategy of economic development. By "import substitution" I mean the reduction in the ratio of imports to domestic production compared to what it would have otherwise been; this definition does not necessarily imply a reduction in the ratio of imports to output compared to historical levels. Indeed, as shown in Table 1, the dollar value of imports in both India and Pakistan grew at least as rapidly as did real GNP between 1950 and 1967.¹ My definition of import substitution verges, of course, on being non-operational, since one cannot know with certainty what the ratio of imports

(Footnote 2 from previous page.)

61; using 1960-61 as a base, her terms of trade declined by 11 percent between 1960-61 and 1966-67. Twenty Years of Pakistan in Statistics. (Central Statistical Office, 1968), p. 129.

¹Table 1 compares the growth in the value of imports in current dollars with the growth of GNP in constant prices. (Throughout this paper growth rates are the compounded rate between the two dates mentioned.) Adjusting the dollar value of imports for price changes would probably not alter the conclusion: the UN index of import prices of all developing countries rose by about .7 percent per year between 1950 and 1967, and the index of export prices of the industrial countries rose by 1.5 percent per year in the same period. International Financial Statistics. If one knew the appropriate exchange rate over time, one could compare directly the ratio of imports to GNP over time in India and Pakistan.

Table 1

Annual Percentage Rates of Growth

	<u>1950-55</u>	<u>1955-60</u>	<u>1960-67</u>	<u>1950-67</u>
	(1)	(2)	(3)	(4)
<u>India</u>				
Real GNP ¹	3.9	4.4	3.9	4.1
Value of imports current dollars	3.9	10.5	2.2	5.1
<u>Pakistan</u>				
Real GNP ²	1.8	3.6	5.8	3.9
Value of imports current dollars	-6.5	17.7	7.7	6.1

Sources: Gross National Product (A.I.D., July 1968).

International Financial Statistics (various issues)

¹Fiscal year beginning April 1.

²Fiscal year beginning July 1.

to production would have been under a different set of policies.¹ I believe, however, that an examination of both public statements by officials and the government's policies would support the statement that the governments of both countries gave a fairly high priority to import substitution.

As a prelude to the rest of the paper, it may be of interest to speculate on the reasons for the adoption of an import substitution policy in India and Pakistan.² First, such a policy may have been considered a means towards the achievement of a faster rate of economic growth. For example, it might just happen that the domestic production of the commodities a country now imports have more external economies--both static and dynamic--than the goods it would export, and so the government would encourage the domestic production of the country's existing import bill. Alternatively, following Hirschman, government officials might feel that the principal constraint on development is the inability of potential domestic investors to decide where to invest, with the consequence that they consume rather

¹My definition also excludes any "natural" decline in the ratio of imports to domestic production as economic growth occurs because, for example, services become a larger share of GNP.

²While the need for revenue partially explains the use of tariffs, it does not explain the use of licensing to achieve import substitution. I do not think that an important objective of protection in India and Pakistan was to protect the (unknown) scarce factor of production.

than invest. As imports are proof of a domestic market, an import substitution policy might induce people to make an investment decision--some investment is better than no investment--and ultimately people, according to the argument, would be willing to invest in other areas, including potential exports.

A second reason for pursuing an import substitution policy stems from the belief that the country's potential exports face a dismal future regardless of what policies the country adopts, and so the country is forced to economize on its future use of foreign exchange as a "second-best" policy. Like many aspects of economic policy, this belief in stagnant exports can become a self-fulfilling prophecy. This point is discussed in more detail in Section II.

The desire for economic "independence" was probably another reason for import substitution policies in both India and Pakistan. Shortages of certain commodities in world markets during the Korean War, the easy analogy between India or Pakistan and the only developed countries of comparable populations and land areas (USA and USSR), the danger of being dependent on foreign suppliers in case of World War III, and the difficulty of some types of economic planning in an "open" economy¹ all combined in India and Pakistan with the emotional desire to be independent

¹For a discussion of the implications for French economic planning of increased French reliance on foreign markets and foreign suppliers, see Bela Balassa, "Whither French Planning," Quarterly Journal of Economics, LXXIX (November 1965), pp. 537-554.

economically as well as politically after 1947. Thus import substitution became an objective per se. To the extent that the Indian and Pakistani governments followed the principle of comparative advantage in determining which imports to produce domestically--produce at home those commodities for which the ratio of (eventual) domestic costs to world prices is smallest--there was a conflict with the objective of self-sufficiency. India and Pakistan may be more dependent now on foreign suppliers than formerly, in the sense that their economy now relies heavily on certain "essential" imports, e.g., petroleum in both countries, foodgrains in India.

A final reason¹ for having followed an import substitution strategy

¹The economists' usual assumption notwithstanding, domestic inputs--natural resources and (to a large degree) labor--are not always very mobile within a country, and so any government trade policy, such as "import substitution" or "export promotion," also has implications for the geographic distribution of employment and income. As Baer notes, in Brazil, "the foreign export surplus of the northeast resulting from the industrialization policy centered in the south, which has led the northeast to buy in the south instead of abroad at less favorable terms of trade, implies a transfer of income from the poor to the richer section of the country." Werner Baer, Industrialization and Economic Development in Brazil (Richard D. Irwin, 1965), p. 177. The analyst's problem is whether to treat this income redistribution as a cost or as a benefit of the nation's foreign trade policy.

stems from the existence of uncertainty in the world and the asymmetrical rewards and penalties to those officials associated with the success and failure of policies. Suppose a government official must choose between two investment projects: one to produce export commodities (and hence to import more) and one to produce the imported commodity domestically. Suppose all world prices prove to be lower than he anticipated. The export project will show a financial loss which (barring devaluation) will be apparent to everyone; the import substitution project, on the other hand, can be sustained through higher tariffs or smaller quotas, whose precise costs are impossible to ascertain and which do not show in the government's budget. Similarly, if world prices are higher than anticipated, the failure to have built the export project will only be apparent to those who follow world export markets, while the failure to have built the import-substitution project will be apparent to all who are purchasing the import. This argument is not a justification for import substitution policies, though it may partially explain their popularity with officials.

Until recently, both India and Pakistan belonged to the group of developing countries that promoted import substitution by means of quantitative controls on imports combined with an overvalued exchange rate¹ rather than relying solely on tariffs and subsidies. It is very difficult

¹For a general discussion of this phenomenon, see Charles Kindleberger, "Liberal Policies vs. Controls in the Foreign Trade of Developing Countries," AID Discussion Paper No. 14 (AID, April 1967).

to identify when quantitative controls became significant. India and Pakistan have had some sort of import licensing since Independence, and I found it impossible to trace the fluctuations over time in the complex set of policies.¹ In the absence of time series comparing actual domestic prices to world prices plus tariffs, one might argue that import licenses became important in determining resource allocation in the context of a "foreign exchange" crisis--around 1953 in Pakistan and about 1958 in India.²

¹For example, in May 1967 the Indian government added 80 items to the list of goods that cannot be imported and also "virtually removed" all restrictions on "maintenance imports" of 59 industries. What is the net effect of these two actions? Exchange Restrictions, 19th Annual Report (International Monetary Fund, 1968), p. 148.

²Pakistan's exports declined from \$763 million in 1951 to \$533 million in 1952; imports, on the other hand, rose from \$549 million in 1951 to \$630 million in 1952, and total foreign exchange reserves fell from \$539 million in 1951 to \$257 million in 1952 (as compared to an annual average of \$448 million from 1949 through 1950). Pakistan's imports fell by 44 percent in 1953, to \$350 million. In India, foreign exchange reserves averaged \$1,870 million between 1951 and 1955 and then fell in three years to \$722 million in 1958. After averaging \$1.3 billion per year in 1953-1955, India's imports rose to \$1.7 billion in 1956 and to \$2.2 billion in 1957 and then fell to \$1.8 billion in 1958. Data are from International Financial Statistics.

Papanek gives several explanations for the Pakistan government's opting for direct controls rather than taxes and subsidies, and this list probably applies equally well to India: (i) the effects of direct controls were thought to be more certain, (ii) civil servants were thought to be more competent than businessmen, (iii) Pakistan had inherited an efficient system of controls from the British, (iv) there was a greater scarcity of economic data and economic sophistication than of administrators, (v) civil servants and some businessmen had a self-interest in perpetuating a system of direct controls, and (vi) there was an ideological reluctance to use the marketplace to allocate resources.¹

To this list one could add several other reasons. There may be a conflict between political cohesion and economic efficiency. In a purely competitive model the marketplace gives all resources to the most efficient producer, but direct controls allow a compromise allocation. People who must continue living together may prefer a compromise situation to a "winner take all" situation.² In the real world, with "distortions" in many markets (e.g., capital market, labor market), it is possible that the marketplace will not allocate scarce imports to the most "efficient" firms. The empirical question is whether an imperfect marketplace does a better job than an imperfect bureaucracy. Finally, in both India and Pakistan the government (including those corporations with the government as a major stockholder) is a large importer; many government

¹Gustav F. Papanek, Pakistan's Development Social Goals and Private Incentives (Harvard University Press, 1967), pp. 112-114.

²This hypothesis was suggested to me by Laura Nader, an anthropologist, who developed it in trying to explain a community's choice between the use of a court system and an administrative system for settling disputes.

managers may dislike paying import taxes--which raise the firm's financial costs--and prefer obtaining imports via a licensing system controlled by fellow civil servants.¹

One can list several attributes of the Indian and Pakistani system of controlling imports. The first two listed below are features of any system of import substitution, and the last eight are features of a licensing system:

(1) Investment in agriculture was discouraged relative to industry, as it was considered easier to expand domestic industrial production than domestic agricultural productions, at least partially because at the alleged "irrationality" of the peasants. Agriculture was also neglected in terms of the incentives it received via the prices for its inputs and its output.² The stagnation in agriculture adversely affects industrial growth by driving up money wages as food prices rise and by curtailing exports (and hence imports of industrial inputs).

(2) Exports were discouraged relative to production of import substitutes.

(3) While excess capability is not a logical concomitant of import licensing, it was in fact ubiquitous in India and Pakistan because a firm's licenses for imports were usually linked to its "rated" capacity, and so the firm frequently did not have the option of expanding output by running a second shift. In Pakistan, the amount of single shift capacity in use (based on a survey

¹Having private imports determined by tariffs and public imports by licensing may be considered by private firms to be "unfair." Having public firms pay the tariff and then get reimbursed by the Ministry of Finance may not satisfy the managers of public firms as much as getting imports duty-free.

²For a study of this factor in Pakistan's development, see Stephen R. Lewis, Jr., "Effects of Trade Policy on Domestic Relative Prices: Pakistan, 1951-64," American Economic Review (March 1968), pp. 60-78.

of 65 plants) was only 53 percent in the second half of 1963.¹ A survey of 140 industries estimated that in 1964 Indian industry was running at about 82 percent of "desirable" output. This average figure, however, is heavily influenced by textiles, basic metals, and food and tobacco, which account for about 70 percent of manufacturing value added and were operating at over 85 percent of "desirable" output in 1964. Several other Indian industries were running at much lower levels of "desirable" output in 1963: chemicals-45 percent; metal products-46 percent; electrical machinery-58 percent; other machinery -63 percent; and transport equipment-64 percent.² The import control system is not, of course, the sole explanation of excess capacity. The necessity to learn how to operate a new plant, in a period of a high rate of investment in industry, will also lead to excess capacity.³

¹Based on an A.I.D. survey cited in paper by Walter P. Falcon and Stephen R. Lewis, Jr., "Economic Policy in Pakistan's Second Plan," (mimeo, November 1966), p. 13.

²National Council of Applied Economic Research, Under-Utilization of Industrial Capacity (New Delhi, 1965), p. 8. "Desirable" is based on a judgment of which industries it would be technically feasible to run two or three shifts.

³Hogan gives a formula for the percentage of excess capacity. For example, if industrial gross investment is growing at an annual rate of 10 percent, if capital lasts an average of 10 years, and if the learning period is two years, then at a point in time only 71 percent of installed capacity will be used. W.P. Hogan, "Some Results in the Measurement of Capacity Utilization," American Economic Review, Vol. 59 (March 1969) pp. 183-184.

(4) Import licensing leads to large inventories investment (in addition to that caused by fluctuating total imports). While licensing gives the government more assurance than does the marketplace in controlling the level of total imports, individual firms have less certainty about acquiring the amount of imports necessary to achieve the most profitable output level, since private profitability is not given much consideration in the allocation of licenses as practiced in India and Pakistan. One might argue that corporations would reduce inventories most by having enforceable import contracts with the government, which would require the government either to hold large foreign exchange reserves or to stabilize export earnings and capital flows.¹

(5) The control system absorbs the time of a large group of talented people, both those in the government who administer it and those in the private sector who respond to it.

(6) Import licensing may lead to excessively capital-intensive methods of production for those firms lucky enough to get import licenses (this is in addition to the capital intensity resulting from the pressures on firms to expand their plants rather than to run extra shifts). One finds that in India between 1957 and 1965 industrial output rose at an annual rate of 7.9 percent and employment at an annual rate of 3.6 percent; in Pakistan between 1957 and 1964 industrial output increased at an annual rate of 9.9 percent and employment by 6.3 percent per year.²

¹This hypothesis was stimulated by Galbraith's discussion of the corporation's response to uncertainty. John Kenneth Galbraith, The New Industrial State (Houghton Mifflin Company, 1967), ch. 4.

²Data on employment in manufacturing are from Yearbook of Labour Statistics 1967; data on industrial output are from International Financial Statistics.

One would expect output to grow faster than employment;¹ the as yet unanswered question is to what extent there could have been still further substitution of labor for capital if relative market prices had been different for labor and capital. As the Indian import liberalization for certain industries proceeds, data may become available to compare their performance with other industries. In Pakistan, which has liberalized by commodity rather than by industry, such a comparison would seem more difficult. To what extent is the slightly lower annual rate of growth of productivity per industrial worker in Pakistan (3.6 percent versus 4.3 percent) due to India's having begun its import liberalization seven years later than Pakistan?

(7) It is difficult to establish new firms, since a potential producer has no historical output as a basis for receiving import licenses. On the other hand, giving a new firm an import license is a good way for the government to insure its financial success.

(8) Small firms may be discriminated against, since they cannot compete with large firms in keeping full-time personnel in the capital to watch and influence the allocation of import licenses. On the other hand, Papanek reports that in Pakistan "the established firm, especially if small and inefficient, was glad to be protected from competition. Political support for this form of protection was widespread."²

(9) Firms are encouraged to locate near the capital in order to have access to officials.

(10) The value of imports rose at 9.8 percent per year in Pakistan between 1953 and 1963 and at 6.8 percent per year in India between 1958

¹In the USA between 1957 and 1965, employment in manufacturing rose at an annual rate of .7 percent while production rose by 4.6 percent per annum. Economic Report of the President 1969 (Washington, 1969).

²Gustav F. Papanek, Pakistan's Development, Social Goals and Private Incentives (Harvard University Press, 1967), p. 113.

and 1965. Even if the bureaucracy had been able efficiently to allocate a small amount of imports, it may have become increasingly difficult for the administrators of the import system to allocate the much larger pool of foreign exchange, including all the non-project foreign aid that was offered. At least some officials in both the donor governments and the recipient governments had an interest in increasing, or at least maintaining, the flow of foreign aid and were unable to find enough large capital projects to absorb quickly the desired flow of foreign aid. For example, U.S. economic aid to Pakistan averaged \$121 million per year between 1953 and 1958 and \$314 million per year between 1959 and 1965.¹

Some of these aspects of the import licensing system gradually became apparent to some government officials and private citizens in both India and Pakistan and to some foreigners. Papanek estimates that "measurable losses" from Pakistan's import control system were at least Rs. 650 million, or about 2 percent of GDP and 19 percent of "monetized investment" in 1959-60.²

Between 1959 and 1964 Pakistan gradually increased the proportion of its imports that could be "freely" imported, increased the tariff and other fiscal charges on many of its imports, and introduced subsidies

¹Data are for U.S. fiscal years and are from U.S. Overseas Loans and Grants (A.I.D., 1967).

²Gustav F. Papanek, Pakistan's Development Social Goals and Private Incentives (Harvard University Press, 1967), p. 123.

for many exports. In 1966 India devalued the rupee, reduced some tariffs, changed some export subsidies, and announced a policy of allowing the free importation of raw materials and spare parts for 59 industries, whose output covered about 70 percent of the "organized" industrial sector. While one might have expected these policies to have some measurable short-run impact, it is probably impossible to disentangle their overall effects from those of the Kashmir War and the bad monsoons of the mid-1960's.¹ One will never, of course, be able to answer with certainty the question of what would have happened in India and in Pakistan in the absence of these new import policies. There are scattered bits of evidence that both countries were developing very high cost industrial sectors, which was particularly

¹One can cite specific examples of the benefits of import liberalization, e.g., small engineering firms were able to import pig iron to produce pumps for tubewells in West Pakistan, though other government policies made the installation of tubewells privately profitable. Mason concludes "the immediate consequences of the 1964 actions on industrial output in Pakistan were much more the result of the increase in the level of commodity imports than of any change in their allocation. Given time, the abandonment of licensing procedures would no doubt have brought market forces more effectively into play. As events conspired, however, the trade liberalization measures were one of the casualties of the Indo-Pakistan conflict." Edward S. Mason, Economic Development in India and Pakistan (Harvard Center for International Affairs, 1966), p. 45.

serious if one accepts the view¹ that ultimately their exports should be mainly industrial products. Lewis and Guisinger's study of Pakistan indicates that several industries--such as sugar, edible oils, silk and art textiles, wearing apparel, electrical appliances, motor vehicles, rubber products, fertilizer, and metal products--were producing commodities in 1963/64 whose value at world prices was less than the value at world prices of their inputs.² Papanek, on the other hand, argues that Pakistan became an efficient producer of jute textiles and of cotton yarn.³ A

¹"...India...or Pakistan decidedly do not have an agricultural resource base sufficiently favorable or varied to enable them to participate in the international trading community over the long haul on the basis of traditional agricultural export lines....Ultimately the dualistic economy must be able to increasingly shift from the production of traditional natural resource-oriented agricultural commodities to the production and export of industrial goods embodying larger quantities of the available domestic labor resources and indigenous ingenuity." John C. Fei and Gustav Ranis, Development of the Labor Surplus Economy: Theory and Policy (Richard D. Irwin, 1964), p. 119.

²Stephen R. Lewis, Jr., and Stephen E. Guisinger, "Measuring Protection in a Developing Country: The Case of Pakistan," Journal of Political Economy (November/December 1968).

³Gustav F. Papanek, Pakistan's Development, Social Goals and Private Incentives (Harvard University Press, 1967), pp. 61-67.

study by the GATT indicates that Taiwan, whose total industrial production is much smaller than India's, exported \$50 million of "engineering products" in 1966, as compared to India's exports of \$28 million.¹

In addition to high production costs, one wonders to what extent the entrepreneurial attitudes of the country have been adversely affected by the policy of import substitution via import quotas. As Kindleberger and Bhagwati have shown,² protection behind quantitative restrictions has different economic consequences from protection behind tariffs even when the same amount of imports occurs; in particular, monopoly profits are created. How does the creation of monopolies affect the country's rate of investment and its propensity to innovate? At the macro level, recent studies of five Latin American countries and of the Philippines suggest that the relative importance of the "residual"--the fraction of the observed growth of output not explained by the growth of labor and of

¹International Trade 1967 (Geneva: GATT, 1968), p. 60. By major types of "engineering goods," the comparison is as follows:

	<u>India</u>	<u>Taiwan</u>
	<u>\$ million</u>	
industrial and agricultural machinery	8	14
research-intensive equipment	2	2
consumer durables	7	24
passenger cars and parts	2	0
heavy transport equipment	2	0
miscellaneous	7	9
total	<u>28</u>	<u>49</u>

²Charles P. Kindleberger, International Economics (Richard D. Irwin, 1958), pp. 621-623 and Jagdish Bhagwati, "On the Equivalence of Tariffs and Quotas," Trade, Growth, and the Balance of Payments (Chicago: Rand McNally and Co., 1965), pp. 53-67.

physical capital--declined during the period of import substitution.¹ Is this result also true for India and for Pakistan? Even if it is, might the decline in the importance of the residual be more than offset by a higher rate of investment? For example, in Brazil, Chile, and Colombia the rate of growth of output was higher in 1955-64 than in 1940-45 even though the residual was relatively more important in the earlier period.²

¹Henry Bruton, "Productivity Growth in Latin America," American Economic Review LVII (December 1967), pp. 1099-1116 and Jeffrey G. Williamson, "Dimensions of Postwar Philippine Economic Progress," Quarterly Journal of Economics, LXXXVIII (February 1969), pp. 93-109.

²The rate of growth of output and the relative importance of the residual are positively related in Argentina, Mexico, and the Philippines.

II

Perhaps the most common argument for the importance of a developing country to expand its exports is to pay for its growing imports of commodities. In the growth models, for example, of Ricardo, Arthur Lewis, and Fei and Ranis, the importation of cheap food allows the "industrial" (or "capitalistic") sector to continue to expand in the face of stagnant agricultural production.¹ Economists have, of course, suggested other effects of expanding exports besides paying for additional imports. Adam Smith observed that larger exports--as one way of expanding the market--might increase workers' productivity by inducing innovations and by improving their dexterity as output rose. Less well-known is Keynes' view that larger exports unaccompanied by larger imports would increase foreign exchange reserves; in a country where the supply of money is directly connected to the quantity of these reserves, the resulting increase in the money supply would--by the familiar Keynesian process--lower interest rates and thereby stimulate domestic investment.² Others have suggested

¹A country lacking workers may import people and use exports to finance remittances.

²"The history of India at all times has provided an example of a country impoverished by a preference for liquidity amounting to so strong a passion that even an enormous and chronic influx of the precious metals has been insufficient to bring down the rate of interest to a level which was compatible with the growth of real wealth." J.M. Keynes, The General Theory of Employment, Interest and Money (New York: Harcourt, Brace, and Co.), p. 337.

that rising exports allow a country to pay off its past foreign debt or to acquire new foreign private debt¹ and expose the country's inhabitants to the healthy winds of competition. Finally, there is the group of theories which attributes such things as rising domestic savings or shifts in domestic resources to expanding exports.²

A few years ago M. Singh and I³ independently concluded, by examining market shares, that the stagnation of India's exports in the 1950's was, to a large extent, due to Indian policies, and I suggested these policies were adopted because export promotion conflicted with other Indian objectives. In this section I will examine briefly the trends in the exports of both India and Pakistan in the 1960's.

¹To the extent that foreign aid is viewed as filling a foreign exchange "gap," the flow of foreign public capital may be inversely related to a developing country's success in promoting its exports.

²See the discussion, for example, in Charles P. Kindleberger, Economic Development (McGraw-Hill Book Co., 1958), pp. 239-259 and Richard E. Caves, "'Vent for Surplus' Models of Trade and Growth," Trade, Growth and the Balance of Payments (Rand McNally & Co., 1965).

³Manmohan Singh, India's Export Trends and the Prospects for Self-Sustained Growth (Oxford: Clarendon Press, 1964) and Benjamin I. Cohen, "The Stagnation of Indian Exports, 1951-1961," Quarterly Journal of Economics, LXXVIII (November 1964), pp. 604-620.

Table 2 shows export data for 1950 through 1967. As is well known, the export earnings of the non-oil producing developing countries grew less rapidly than did total world exports during this entire period.¹ It is less well known that the export earnings of the non-oil producing countries grew considerably more rapidly in the 1960's than many people anticipated in the early 1960's--at an annual rate of 5.7 percent in the 1960's versus 3.1 percent in the 1950's. This rate of growth of exports in the 1960's is fairly close to the 6 percent annual rate which Raul Prebisch, at UNCTAD I, felt was necessary (if the real GNP of the developing countries were to grow at 5 percent per annum)² even though none of his suggested policies was adopted. The actual annual rate of growth of exports of all developing countries (including oil producers) in the 1960's--6.1 percent³--

¹This is true even if one excludes all intra-EEC trade and intra-EFTA trade since 1955. Excluding all such trade--trade "diverted" as well as trade "created"--overstates the impact of these two trade arrangements on the growth of world exports.

²Towards A New Trade Policy for Development (New York: United Nations, 1964), p. 4. Between 1960 and 1967 real GNP of the developing countries grew at an annual rate of 4.9 percent. Gross National Product (A.I.D., July 1968).

³Preliminary data indicate that export earnings of developing countries rose by about 9 percent in 1968, bringing the annual rate of growth from 1960 through 1968 to 6.5 percent. International Financial News Survey (March 7, 1969), p. 65.

Table 2

	Exports				annual percentage change				
	1950	1955	1960	1967	1950- 55	1955- 60	1960- 67	1950- 60	1950- 67
	(\$million)								
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
World	55,200	83,000	112,300	190,500	8.5	6.3	7.8	7.3	7.6
Intra-EEC	n.a.	5,647	10,246	24,513	-	12.6	13.3	-	-
Intra-EFTA	n.a.	2,589	3,491	7,018	-	6.1	10.5	-	-
Rest of world	n.a.	74,764	98,563	158,969	-	5.7	7.1	-	-
Total less developed countries	17,500	22,300	26,100	39,600	5.0	3.2	6.1	4.1	4.9
Oil producers ¹	3,252	5,194	6,755	11,042	9.8	5.4	7.3	7.5	7.5
Other less developed countries	14,248	17,106	19,345	28,558	3.8	2.5	5.7	3.1	4.2
India	1,146	1,276	1,331	1,613	2.2	.9	2.8	1.5	2.0
Pakistan	489	401	393	645	-3.8	-.4	7.4	-2.2	1.6

Sources: International Financial Statistics (April 1969 and 1965/66 Supplement).
Monthly Statistics Foreign Trade (Statistical Office of the European Communities).

¹ Brunei, Iran, Iraq, Kuwait, Libya, Netherlands Antilles, Saudi Arabia, Trinidad, Venezuela.

may also be compared with Balassa's detailed projections made in the early 1960's. He projected an annual rate of growth of export earnings between 1960 and 1970 (in current prices) of all developing countries ranging, depending on the assumptions, from 3.2 percent to 3.8 percent.¹ His projected increase in exports during the entire decade of \$8.5 billion to \$10.3 billion over the 1960 level was actually achieved by 1966.

India's export earnings grew slightly faster than Pakistan's during the entire period 1950 to 1967 (2 percent per annum versus 1.6 percent per annum). While Pakistan's export earnings declined during the 1950's, in the 1960's they grew more rapidly than the average for all non-oil producing developing countries. India's export earnings grew almost twice as rapidly in the 1960's as in the 1950's, but even in the 1960's they grew at about one-half the annual rate of the average non-oil producing developing country.

To what extent is the above average rate of growth of Pakistan's exports and the below-average rate of growth of India's exports due to differences in their policies and to what extent is it due to differences

¹Bela A. Balassa, Trade Prospects for Developing Countries (Richard D. Irwin, 1964), p. 95. Part of Balassa's error may be in his overly pessimistic projections of the rate of growth of real GNP in the OECD countries; while he projected an annual rate of growth ranging from 4.1 percent to 4.7 percent, the actual annual rate of growth of real GNP between 1960 and 1967 was 5 percent. Ibid, pp. 34, 35, 44.

in the composition of their exports? As a proxy for world demand, I have used the value of imports by the European OECD countries,¹ by the U.S. and Canada, and by Japan, which in 1965 purchased 55 percent of India's total exports and 46 percent of Pakistan's total exports. Table 3 compares European OECD imports from India and Pakistan with total imports for each of 14 commodities; Table 4 gives a similar comparison for the U.S. and Canada, and Table 5 presents Japanese data. In 1965 these 14 commodities accounted for 71 percent of India's total exports and for 84 percent of Pakistan's total export earnings.

European imports of these commodities from India declined in the 1960's. For the 13 commodities which Europe imported from India in 1967, India's share of total imports declined between 1960 and 1967 for all except tobacco, raw cotton, raw jute, and sugar. If India had maintained her 1960 share of European imports of each of these 13 commodities in 1967, Europe's imports of these commodities from India would have been \$560 million in 1967 rather than the actual \$372 million.

In two respects, Pakistan's performance in Europe seems quite different. Europe's imports of these commodities from Pakistan increased very slightly in the 1960's. Of the 11 commodities which Europe imported from Pakistan in either 1960 or 1967, Pakistan's share of total imports rose between 1960 and 1967 for all commodities except tea, oilcakes, raw jute, and cotton yarn. However, the poor performance for raw jute--where her share of imports fell from 93 percent in 1960 to 79 percent in 1967--and oilcakes--where her share of imports fell from 10 percent in 1961 to

¹Excluding Finland.

Table 3

European OECD Imports from India and Pakistan

<u>Commodity (SITC No.)</u>	<u>1960</u> <u>\$million, cif</u> <u>(1)</u>	<u>1967</u> <u>(2)</u>	<u>Annual Percentage</u> <u>Rate of Growth</u> <u>1960-1967</u> <u>(3)</u>
<u>Cotton textiles (652.1 + 652.2)</u>			
Total	652	510	-3.4
India	75	29	-12.7
Pakistan	12	12	0
<u>Jute products (653.4 + 656.1 + 657.5 + 657.6)</u>			
Total	297	458	6.4
India	42	48	2.0
Pakistan	9	17	9.5
<u>Tea (074)</u>			
Total	381	359	- .9
India	199	160	-3.1
Pakistan	4	0	-
<u>Manganese ore (283.7)</u>			
Total	88	88	0
India	16	5	-15.8
Pakistan	0	0	0
<u>Cotton yarn (651.3 + 651.4)</u>			
Total	117	137	2.3
India	4	5	3.2
Pakistan	1	1	0
<u>Leather (611)</u>			
Total	213	317	5.8
India	52	42	-3.0
Pakistan	2	19	38
<u>Iron ore (281.3)</u>			
Total	831	811	- .3
India	42	6	-24
Pakistan	0	0	0

Table 3 (continued)

<u>Commodity (SITC No.)</u>	<u>1960</u>	<u>1967</u>	<u>Annual Percentage Rate of Growth 1960-1967</u>
	<u>\$million, cif</u> (1)	<u>(2)</u>	
<u>Sugar</u> (061)			
Total	444	554	3.2
India	0	8	-
Pakistan	0	2	-
<u>Spices</u> (075)			
Total	43	55	3.5
India	4	4	0
Pakistan	0	0	0
<u>Oil cakes</u> (081.3)			
Total	344 ¹	687	12.2
India	32 ¹	24	-4.7
Pakistan	34 ¹	6	-2.5
<u>Tobacco</u> (121)			
Total	614	771	3.3
India	28	36	3.7
Pakistan	0	1	-
<u>Raw Cotton</u> (263)			
Total	1,088	890	-2.8
India	3	4	4.2
Pakistan	6	9	6.0
<u>Rice</u> (042)			
Total	65	100	6.3
India	0	0	0
Pakistan	0	1	-
<u>Raw jute</u> (264)			
Total	121	154	3.5
India	1	1	0
Pakistan	114	122	1.0
<u>Total above commodities</u>			
Total	5,298	5,891	1.6
India	498	372	-4.0
Pakistan	182	190	.6
<u>Total imports</u>			
India	568	532	-.9
Pakistan	175	222	3.4

Sources: Various issues of Trade by Commodities (OECD).

¹1961.

Table 4

United States and Canada Imports from India and Pakistan

<u>Commodity</u>	<u>1960</u> <u>\$million, fob</u> <u>(1)</u>	<u>1967</u> <u>(2)</u>	<u>Annual Percentage</u> <u>Rate of Growth</u> <u>1960-1967</u> <u>(3)</u>
<u>Cotton textiles</u>			
Total	229	210	-1.3
India	18	13	-4.6
Pakistan	4	6	6.0
<u>Jute products</u>			
Total	248	266	1.0
India	100	174	8.3
Pakistan	7	28	22
<u>Tea</u>			
Total	81	80	- .2
India	23	15	-5.9
Pakistan	0	0	0
<u>Manganese ore</u>			
Total	85	61	-4.7
India	14	4	-16.4
Pakistan	0	0	0
<u>Cotton yarn</u>			
Total	17	n.a.	-
India	0	n.a.	-
Pakistan	0	n.a.	-
<u>Leather</u>			
Total	51	87	7.9
India	1	3	17.0
Pakistan	0	1	-
<u>Iron ore</u>			
Total	322	475	5.7
India	0	0	0
Pakistan	0	0	0
<u>Sugar</u>			
Total	610	693	1.8
India	0	12	-
Pakistan	0	0	0

Table 4 (continued)

<u>Commodity</u>	<u>1960</u> <u>\$million, fob</u> <u>(1)</u>	<u>1967</u> <u>(2)</u>	<u>Annual Percentage</u> <u>Rate of Growth</u> <u>1960-1967</u> <u>(3)</u>
<u>Spices</u>			
Total	53	50	-1.0
India	11	3	-17.0
Pakistan	0	0	0
<u>Oilcakes</u>			
Total	17 ¹	24	5.1
India	0 ¹	0	0
Pakistan	0 ¹	0	0
<u>Tobacco</u>			
Total	120	168	5.0
India	0	0	0
Pakistan	0	0	0
<u>Raw cotton</u>			
Total	90	97	1.1
India	2	2	0
Pakistan	2	1	-9.4
<u>Rice</u>			
Total	9	10	1.6
India	0	0	0
Pakistan	0	0	0
<u>Raw jute</u>			
Total	9	10	1.6
India	0	0	0
Pakistan	9	8	-1.7
<u>Total above commodities</u>			
Total	1,941	2,231	2.0
India	169	226	4.2
Pakistan	22	44	10.4
<u>Total imports</u>			
India	260	337	3.8
Pakistan	37	59	6.9

Sources: Same as Table 3.

¹1961.

Table 5

Japanese Imports from India and Pakistan

<u>Commodity</u>	<u>1960</u> <u>\$million, cif</u> <u>(1)</u>	<u>1967</u> <u>(2)</u>	<u>Annual Percentage</u> <u>Rate of Growth</u> <u>1960-1967</u> <u>(3)</u>
<u>Cotton textiles</u>			
Total	1	7	32
India	0	0	0
Pakistan	0	0	0
<u>Jute products</u>			
Total	2	5	14
India	1	1	0
Pakistan	0	0	0
<u>Tea</u>			
Total	2	7	19.6
India	0	0	0
Pakistan	0	0	0
<u>Manganese ore</u>			
Total	78	38	- 9.7
India	42	9	-20
Pakistan	0	0	0
<u>Cotton yarn</u>			
Total	0	8	-
India	0	0	0
Pakistan	0	7	-
<u>Leather</u>			
Total	3	9	18.8
India	2	4	10.4
Pakistan	0	2	-
<u>Iron ore</u>			
Total	213	718	19.0
India	67	132	10.2
Pakistan	0	0	0
<u>Sugar</u>			
Total	121	177	5.6
India	0	1	-
Pakistan	0	1	-

Table 5 (continued)

<u>Commodity</u>	<u>1960</u> <u>\$million, cif</u> <u>(1)</u>	<u>1967</u> <u>(2)</u>	<u>Annual Percentage</u> <u>Rate of Growth</u> <u>1960-1967</u> <u>(3)</u>
<u>Spices</u>			
Total	3	4	4.2
India	0	0	0
Pakistan	0	0	0
<u>Oilcakes</u>			
Total	0	7	-
India	0	3	0
Pakistan	0	0	0
<u>Tobacco</u>			
Total	14	57	22
India	0	3	-
Pakistan	0	0	0
<u>Raw cotton</u>			
Total	420	443	.8
India	13	18	4.8
Pakistan	17	11	-6.0
<u>Rice</u>			
Total	20	82	22
India	0	0	0
Pakistan	0	0	0
<u>Raw jute</u>			
Total	12	21	8.3
India	0	0	0
Pakistan	10	7	-4.9
<u>Total above commodities</u>			
Total	889	1,583	8.6
India	125	171	4.6
Pakistan	27	28	.5
<u>Total imports</u>			
India	126	259	10.8
Pakistan	32	38	2.5

Sources: 1960 Annual Return of Foreign Trade of Japan
Trade by Commodities (OECD).

1 percent in 1967--more than offset the improved performance in the other 7 commodities. If Pakistan had maintained her 1960 share of European imports of each of these 11 commodities in 1967, Europe's imports of these commodities from Pakistan in 1967 would have been \$249 million rather than the actual \$190 million.

The record is somewhat more optimistic for imports by the United States and Canada. For these 14 commodities, imports from both India and Pakistan grew more rapidly than total imports. For the 9 commodities imported from India in 1967, India's share of total imports declined between 1960 and 1967 for all except jute products, leather, and sugar. If India had maintained her 1960 share of U.S. and Canadian imports for each of these 9 commodities, 1967 imports of these commodities from India would, however, have been \$173 million rather than the actual \$226 million. India's rising share of imports of jute goods and sugar more than compensated for declines in the other commodities.

For the 5 commodities imported by the United States and Canada from Pakistan in 1967, Pakistan's share increased between 1960 and 1967 for all except raw cotton and raw jute. If Pakistan had maintained her 1960 share of U.S. and Canadian imports for each of these 5 commodities, 1967 imports from Pakistan would have been \$44 million rather than the actual \$23 million.

As in Europe, Japan's total imports of the 14 commodities rose more rapidly than her imports from either India or Pakistan in the 1960's. Of the 8 commodities actually imported from India, India's share of Japanese

imports fell for jute products, manganese ore, leather, and iron ore.¹ Of the five commodities actually imported from Pakistan, Pakistan's share of total Japanese imports declined for raw cotton and raw jute. Maintenance of the actual 1960 share of Japanese imports for each commodity would have meant imports from India of \$270 million--compared to an actual \$171 million--and imports from Pakistan of \$37 million--compared to an actual \$28 million.

The faster growth of actual export earnings by Pakistan is due to some extent to a more favorable composition of exports. As shown in Table 6, projected 1967 OECD purchases of these 14 commodities from Pakistan are 34 percent above actual 1960 purchases, as compared to projected 1967 OECD purchases from India being 27 percent above actual 1960 purchases.

Table 6 reveals that for neither India nor Pakistan did the improved competitive position in the United States and Canadian market offset the decline in Western Europe and Japan. Declining market shares are the general rule for India,² and rising market shares--usually from a smaller absolute base--are the general rule for Pakistan in the 1960's, which suggests that Pakistan's export subsidies were more substantial than India's. For example, India's share of European imports of cotton textiles fell from 12 percent in 1960 to 6 percent in 1967 and her share

¹All 1960 data include imports from Portuguese India.

²The impact of the Indian devaluation of 1966 is mixed. Comparing India's share of imports in 1965 and 1967, one finds her share declined in all three markets for manganese ore, iron ore, and cotton textiles; her share rose in all three markets for tobacco. For the other commodities her share rose in some markets, declined in others, and occasionally was unchanged.

Table 6

Imports of Selected Commodities

	<u>1960</u>	<u>1967</u>		<u>Annual Percentage Rate</u>	
	<u>Actual</u>	<u>Actual</u>	<u>Projected</u> ²	<u>of Growth, 1960-67</u>	<u>Actual</u> <u>Projected</u>
<u>Western Europe, cif</u>	<u>\$ Million</u>				
	(1)	(2)	(3)	(4)	(5)
India	498 ¹	372	560	-4.0	1.7
Pakistan	182 ¹	190	249	.6	4.5
<u>United States and</u> <u>Canada, fob</u>					
India	169 ¹	226	173	4.2	.3
Pakistan	22 ¹	44	23	10.4	.6
<u>Japan, cif</u>					
India	125	171	270	4.6	11.6
Pakistan	27	28	37	.5	4.6
<u>Total above</u>					
India	792	769	1,003	- .3	3.4
Pakistan	231	262	309	1.8	4.2

¹1961 data for oilcakes.

²Assuming 1960 share of actual 1967 total imports of each commodity.

of leather imports fell from 25 percent to 13 percent; in the same period Pakistan's share of cotton textile imports remained at 2 percent and her share of leather imports rose from 1 percent to 6 percent. If India and Pakistan had each maintained her 1960 share of each commodity in each major market, purchases by the OECD countries of these commodities would have been 30 percent larger than the actual \$769 million from India and 18 percent larger than the actual \$262 million from Pakistan.

III

The preceding discussion suggests that the similarities between India's foreign trade and that of Pakistan--in terms of both policies and performance--exceed the differences--both currently and over the last 20 years.¹ Both countries still rely to a large extent on import licensing; neither can be confidently said to have produced an export sector which can generate enough foreign exchange to meet the government's announced economic aspirations of the next decade.² Both prefer a policy of a collection of export subsidies to a policy of a large devaluation combined with, perhaps, selective export taxes.³ Neither country attracts much foreign private investment,⁴

¹One can think of other pairs of neighboring developing countries for which this statement would not be true, e.g., Colombia and Peru in the 1960's.

²This statement assumes a continuation of the present level of gross foreign aid, and so a decline in net foreign aid as repayments on past aid increase.

³While some feel that the Indian devaluation of 1966 was designed to allow the elimination of ad hoc export subsidies, it seems that many such subsidies remain.

⁴In 1967 new U.S. private investment (including reinvested earnings) amounted to \$23 million in India. Published data on Pakistan are unavailable, but U.S. investment in all of the Far East excluding India, Japan, and Philippines was only \$120 million in 1967. Survey of Current Business (October 1968), p. 24.

and neither has large foreign exchange reserves.¹

If it is accepted that the relations of India and of Pakistan with the rest of the world have a great deal in common, then one might wonder about the economic benefits and costs of a customs union between the two nations (which, for stylistic convenience, I shall refer to as South Asia). It may be appropriate to discuss the definition of a customs union in the South Asian environment. Economists tend to assume that in the absence of a customs union each country grants "most favored nation" treatment with its tariffs to all countries and that tariffs are the sole means of regulating the composition of imports. These assumptions are unrealistic for India and Pakistan, where licensing seems more important than tariffs in determining the composition of trade flows and where neither India nor Pakistan now grants its neighbor "most favored nation" status in the allocation of import licenses. The distinction between a free trade area (each country having its own set of external tariffs) and a customs union (each country having the same set of external tariffs) is rather fuzzy when licensing dominates, since the essence of licensing is administrative discretion. One could have a common licensing system only if one had a single licensing agency for both countries. A working definition of a "customs union" between India and Pakistan for the rest of this paper is that commodities flow as easily between the two countries as within each country. This

¹Foreign exchange reserves (gold, foreign exchange, and IMF reserves) at the end of 1967 as a fraction of 1967 imports were 24 percent for India and 15 percent for Pakistan.

definition is not stated in terms of free trade between the two countries, as there does not now exist free trade within each country; would India, for example, allow free trade in foodgrains with Pakistan when free trade of foodgrains is not now permitted within India.

The large economics literature on customs unions tends to stress two static benefits to the member nations: (i) trade creation on the basis of production along comparative advantage between the countries to replace each country's producing domestically everything that is not imported from the rest of the world and (ii) economies of scale which are attained by exporting to each other but which are unattainable through exports to the rest of the world, presumably because transport costs and/or foreign tariffs are too high or because member countries' currencies are overvalued. One might also argue that over time the countries will attract more foreign private investment as a customs union than as economically separate nations. I will also discuss three other possible benefits: reduction in transport costs, favorable effects on the terms of trade, and reduction in military expenditures.

Trade diversion stemming from the customs union might injure certain industries in foreign countries, e.g., Pakistan's importing steel from India rather than from the rest of the world. A cost to the governments participating in the customs union is their reduced ability to use the effective exchange rate (nominal exchange rate and taxes and subsidies on foreign trade) as an instrument to achieve their numerous economic objectives. Against this loss must be set the possible gain to each participant of more easily achieving its economic objectives through better coordination

of the policies of the two countries.¹

In the case of India and Pakistan, a reduction in transport costs would be a benefit from a customs union that is frequently overlooked in the theoretical literature.² The ability of East Pakistan to import manufactured goods from eastern India and of western India to import from West Pakistan would release resources that are now used in transportation within Pakistan and within India. One can only guess as to the quantitative importance of these freight costs. Bose estimates that in 1961/62 freight charges between East Pakistan and West Pakistan amounted to about Rs. 37 million.³ I was unable to find estimates of freight costs in eastern India and in western India. As economic growth proceeds, freight costs will surely rise

¹This paragraph, and this entire section of the paper, owe much to Jeffrey Nugent's unpublished study of the Central American Common Market.

²Lipsey's admirable article, for example, does not mention this benefit. R.G. Lipsey, "The Theory of Customs Unions: A General Survey," Economic Journal (September 1960) reprinted in Caves and Johnson, eds., Readings in International Economics (Richard D. Irwin, Inc., 1968).

³Bose estimates major changes between East Pakistan and West Pakistan at Rs. 50 per ton; in 1961/62 West Pakistan imported 128,000 tons from East Pakistan and exported 644,000 tons to East Pakistan. Swadesh Ranjan Bose, Regional Cooperation for Development in South Asia with Special Reference to India and Pakistan (Ph.D. dissertation submitted to University of Cambridge, January 1967), pp. 110, 115.

absolutely and, for some time, probably also rise as a proportion of GNP.¹

Much of the literature on a customs union also tends to assume that it will have no effect on the terms of trade. In the case of India and Pakistan, however, cooperation in the jute industry might allow the two countries to increase their combined export earnings for two reasons. First, acting as a monopolist rather than as aggressive duopolists would permit larger earnings. Second, cooperation in stabilizing the price of raw jute (and hence of jute products) through some sort of buffer stock might well raise the average level of export sales.²

¹Wilfred Owen, Strategy for Mobility (Washington, D.C., The Brookings Institution, 1964), pp. 44-51.

²The following table shows the percentage change in prices of raw jute and of burlap in recent years:

<u>Year</u>	<u>Raw Jute</u>	<u>Burlap</u>
1962	-30	-4
1963	- 5	4
1964	3	-5
1965	17	12
1966	4	8
1967	5	-7

Source: International Financial Statistics, (April 1969).

MacBean reviews the evidence on the significance of fluctuating prices and on the elasticities of supply and demand of raw jute. While discussing policies Pakistan might adopt, he does not consider joint policies. A.I. MacBean, "Problems of Stabilization Policy in Underdeveloped Countries (Illustrated from a Study of Jute in Pakistan)," Oxford Economic Papers, Vol. 14 (October 1962), pp. 251-266.

As for the benefit of trade creation, one wonders whether anyone can predict, even roughly, the size of the gains to the combined national output of India and Pakistan by letting each produce according to comparative advantage. In theory, one might look at the pattern of production and trade around 1947,¹ but much investment and the introduction of new technology reduce the probability that the optimum pattern of production and trade in the 1940's would be near the optimum pattern of 1970. There are a few "obvious" examples, e.g., let East Pakistan grow all of South Asia's raw jute and let India substitute rice for its present raw jute production. What, however, is the quantitative significance of these particular reallocations? While using various methods, the quantitative estimates made of the economic gains of other customs unions are uniformly small--less than 1 percent of national income.²

¹In 1948/49, India accounted for 80 percent of East Pakistan's foreign trade and 53 percent of West Pakistan's foreign trade. M. Akhlaqur Rahman, Partition, Integration, Economic Growth and Interregional Trade (Karachi: The Institute of Development Economics, 1963), p. 88. Rahman notes (p. 101) that "reliable data relating to the prepartition interregional flow of goods and services in undivided India are not available.

²Bela Balassa, "Trade Creation and Trade Diversion in the European Common Market," Economic Journal (March 1967), pp. 1-21; Edwin M. Truman, "The European Economic Community: Trade Creation and Trade Diversion," (Ph.D. dissertation submitted to Yale University, 1967); Harry Johnson, "The Gains from Freer Trade with Europe," Manchester School (September 1958);

It may be easier to guess the economic benefits of economies of scale accruing to specific industries within a South Asian customs union. From the observed experience of other countries, one can measure the reduction in costs if one assumes South Asian cost curves would be the same as those of other countries, and I presume the governments of both countries have made many such estimates. It is not necessarily correct that Pakistan will benefit more from a customs union than India simply because Pakistan's population (and GNP) are about 1/4 that of India. As Adam Smith taught us, the economic size of the market is heavily influenced by transport costs. For example, the farthest point of East Pakistan is about 300 miles away from Calcutta. One can guess that about 121 million Indians now live within 300 miles of Calcutta.¹ Thus, assuming transport costs proportional to distance, Calcutta's economic market would significantly increase if trade with 70 million East Pakistanis became as easy as trade within India. Similar calculations could be done for the industrial areas of northwest India.

Footnote 2 continued from previous page.

Tibor Scitovsky, Economic Theory and Western European Integration (Stanford University Press, 1958); J. Wemelsfelder, "The Short-Term Effect of the Lowering of Import Duties in Germany," Economic Journal (March 1960).

¹The 1961 census reveals that 102 million Indians lived in districts within a 300 mile radius of Calcutta. I assume an annual rate of population growth of 2.5 percent.

Besides commodities for which demand is a function of the number of people at various levels of per capita income, there are commodities for which demand is more a function of some aggregate, such as total investment or total agricultural production. For example, steel used for private automobiles depends on the number of people with high incomes, but steel used for construction depends on the size and composition of investment. What would be the reduction in costs for such items as steel and fertilizer if East Pakistan and eastern India could use the same production facility? Papanek concludes that "for most of Pakistan's industry...inadequate plant size was not the problem. Firms in such industries as cotton textiles, jute, cement, and simple metal-working could reach the optimum scale within the Pakistan market. This problem may be more relevant for future development; some petrochemical processes, for instance, involve substantial economies of scale, and optimum-sized plants may be too large for domestic demand."¹ For India, national markets may appear large enough to capture all economies of scale provided one abstracts from transport costs. Allowing for transport costs, however, may mean that for some commodities eastern India and northwest India might be supplied more cheaply from a regional plant if it could also sell to Pakistan. Furthermore, even if the present national market in either Pakistan or India is large enough to allow one firm to capture all economies of scale, one may desire many firms in each industry to capture also the benefits of competition.

¹Gustav F. Papanek, Pakistan's Development, Social Goals and Private Incentives (Harvard University Press, 1967), p. 107.

Perhaps the major benefit to each country of analyzing the benefits of a customs union would be the reduction in military expenditures, which amount to about 3 percent of GNP in both India and Pakistan.¹ This reduction might occur in one of two ways. If the economic benefits of a customs union are judged to be small, then one might argue that the economic benefits of either country's conquering the other would also be small.² If this argument is accepted by both governments, then one might conclude that military expenditures could be substantially reduced.³ If the benefits of a customs union are judged to be large, then the steps to build the mutual trust to form the union would also affect military spending. A reduction in military expenditures could, of course, logically occur in the absence of a customs union and may well be a political prerequisite.

¹In 1967-68 India's defense budget was about \$1.1 billion and Pakistan's about \$436 million. New York Times (May 26, 1967 and June 11, 1967).

In Latin America military expenditures average about 1 percent of GNP.

²This assumes that the economic benefits of a common market are the same for South Asia as for a customs union.

³This argument assumes that each country determines its military expenditures in terms of what the other is spending rather than by what third countries are spending. Even if third country expenditures are relevant, it is conceivable that there would be economies if India and Pakistan had a joint defense against third countries and no need of defense against each other.

Finally, what can one say about the optimum sequence of measures to achieve the objective of a customs union? One can list several projects which might well benefit both India and Pakistan, and some of these--such as allocation of water in east India and East Pakistan, a buffer stock for raw jute--have no logical connection with the creation of a customs union, except as they help to build mutual trust. Other steps--such as a payments arrangement or the aid donors' allowing tied aid funds to each country to be spent in the other country-- could be related to a customs union. Economists tend to assume that all relevant functions are known with perfect certainty and then proceed to develop "marginal" decision rules for dealing with small changes in the parameters. Decision-makers, on the other hand, tend to start with the observation that the future environment is highly uncertain, that present actions tend to have unforeseen consequences, and that social experiments are frequently irreversible. This view of the world also leads to marginal decisions, an assessment of their consequences, and then to further small changes. The attempts to bring about customs unions in Europe, Central America, and Latin America have all proceeded by small steps, but each followed a different sequence. If one wants a customs union, one might conclude that almost any first step is better than no motion due to inability to agree on the best first step.