The declared goal of the Congress Government in India is to build a socialistic pattern of society. In order to build a "socialistic" society, the Second Five Year Plan aims not only at a rapid increase in the aggregate national income, but it also seeks to secure a simultaneous and balanced progress in the direction of raising the standard of living, increasing employment opportunities and reducing economic and social inequalities with a wide measure of social justice.

The Second Five Year Plan has commenced operating from April 1, 1956. After a long deliberation, it was finalised that investment in the public and private sectors would be Rs. 4800 and Rs. 2300 crores respectively. The public sector has been enlarged by Rs. 500 crores and the private sector by Rs. 100 crores from the original estimate of the plan-frame. The total development expenditure of Rs. 4800 crores on the public sector is not a fixed target for the entire plan-period. The plan will be under constant observation by a group of experts and modified as it is implemented. It may be that at the end of the plan-period, the size of the plan will be different from what it is to-day.

Outside the plan, Rs. 4500 crores is proposed to be spent during the next five years. Therefore, the total expenditure to be incurred on government account will amount to Rs. 9300 crores over the entire plan-period. Besides this, a large amount will be spent on a large part of economic activity by the private sector over which the state will have no direct control.
Thus even in the Second-Five-Year-Plan, a vast field of economic activity will remain outside the state-control. If the private sector does not behave in accordance with certain expectations, the plan may not succeed in achieving the basic objectives.

The greatest danger in the implementation of the Second-Five-Year Plan will arise if inflationary forces tend to develop in the course of the execution of the plan. Inflation will not only distort the plan, but will mean a great hardship for the people and the objectives of the plan will be defeated.

In all probability, at the end of the plan period, price-level will be somewhat higher than what it is to-day. If prices rise slowly and gradually, it may not cause hardship for the people; because the income of the people increases with the increase in prices, which represents the money-income of the community. If the increased money income is owned by a few, it will certainly increase to a great extent the hardship of the people as such. Rise in prices will only mean windfall gains for a few and loss for the majority.

Prices are not always determined by the influence of physical factors, such as, the volume of production, cost of production and consumption-demand. Now a days, psychological factors, such as, the state of expectation and behaviour of the businessmen and the consumers have an important influence in determining prices to a large extent. Expecting the price to rise, people will prefer goods to liquid cash.
Businessmen may increase their stock of producer-goods or final products and consumers may like to increase their stock of consumer-goods. As their liquidity will be very high, there may be an increase in the hoarding of precious metals and foreign exchange. The result may be an increase of inflationary pressure.

According to Keynes, psychological factors which play a very important part in the creation of booms and slumps, cannot always be influenced by a monetary policy. In India price expectations are important elements in business decisions especially with reference to change in inventories. Therefore, prices may rise in India owing to psychological factors, even independent of the physical factors which ordinarily should determine the level of prices. As psychological factors cannot be foreseen, they may create difficulties for the planning authorities in the successful implementation of the Second-Five-Year-Plan in India.

Financial Resources of the Second-Five-Year-Plan:

The greatest problem before the economists was in respect of the resources needed to implement the Second-Five-Year-Plan the tentative estimates of financial resources made are as follows:

Rs. 800 crores will be raised by taxation; (Rs 350 crores will be available from current revenues at the existing rates and a sum of Rs. 450 crores by way of additional taxation), Rs. 700 crores from borrowing and Rs. 500 crores from small savings, Rs. 150 crores as the net contribution from the railway, Rs. 250 crores from provident


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fund and other deposit heads and Rs. 800 crores from external assistance. A sum of Rs. 1200 crores is purposed to be raised by deficit financing and Rs. 400 crores will be left as uncovered gap.

There is a sharp difference of opinion between official and non-official circles on the question of the availability of financial resources needed for the plan. According to non-official circles, the resources indicated above are all of a highly doubtful nature, so that they do not inspire in one the requisite sense of confidence as to the resources being fully proportionate to the needs of the plan. According to them, the estimate of Rs. 450 crores by way of additional taxation is highly conjectural and does not accord with the real savings capacity of the country. They have expressed doubt whether borrowing and small savings to the extent of Rs. 700 and Rs. 500 crores respectively could also be expected simultaneously with additional taxation to the tune of Rs. 450 crores.

**SMALL SAVINGS AND PUBLIC BORROWING:**

One of the most useful non-inflationary finance-the-development expenditure methods to finance the development-expenditure is borrowing from the public in the domestic market. It not only reduces private spending but also transfers real resources to the government. As regard borrowings, the official circles hold optimistic views. On the basis of the results in 1954-55 and 1955-56 when borrowings improved averaging about Rs. 100 crores per year, they feel that the plan-target of Rs. 700 crores should not be difficult of fulfilment in the next five years.
Similarly, in regard to small savings, the progress in the last two years of the First-Five-Year-Plan was so satisfactory that the expectation of Rs. 500 crores in the next five years does not seem to be an impossibility. In 1955-56, according to the estimate of the official circles, the total of small savings is expected to reach up to Rs. 65 crores as against Rs 52 crores in the budget.1 Government have been taking various measures to intensify the small savings movement. Under the guidance of the Central Advisory Committee, many voluntary social and women’s organisations have been working for the sale of small savings certificates. The mobilisation of small savings to the tune of Rs. 500 crores may be possible if some special measures are taken to intensify the small savings drives provided inflationary forces, now visible in India, are timely checked. There is a good sign that the State Governments are cooperating with the movement and some of them have created special officers to intensify the small savings drives in co-operation with the National Savings Organisations.

It has already been pointed out on the basis of the results in the last two years, that the official circles are optimistic about raising Rs. 700 crores through public borrowings. In 1954-55 and 1955-56 gross receipts from public loans were actually Rs. 160.4 and Rs. 157.2 crores respectively. 2 In this favourable trend continues in the period of the Second-Five-Year-Plan, the target for public loans is capable of realisation provided market conditions are not adversely affected by financial or other measures. It should be pointed out in this connection that in 1956-61 the Central and the

State-Governments will be required to repay loans which will amount to Rs. 427.01 crores. Consequently, the receipts from public loans should be at least Rs. 1127.01 crores if the target is to be realised, that is, on an average in the five years of the second plan a little above Rs. 228 crores will have to be raised annually by the Central and the State Governments.

**ROLE OF THE INSTITUTIONAL INVESTORS:**

If the annual target is to be realised, the institutional investors who are the main subscribers to these loans, should be encouraged to support the government. In the first plan-period, the institutional investors subscribed to approximately four-fifths of the total public loans. Among them banks and insurance companies are the most important.

**BANKS AS INVESTORS IN GOVERNMENT BONDS:**

The commercial banks hitherto have been important subscribers to government loans. When the commercial banks invest in government bonds, it generally results in a decline in the liquidity of the banks, that is to say, in the ratio of cash holdings to deposits received from the public. Therefore, their lending to the private sectors is reduced to that extent unless the banks reduce the reserve ratio.

On account of the development of banking business in India, investments of all commercial banks in government securities rose by Rs. 30.34 crores, from Rs. 341.12 crores in 1953-54 to Rs. 371.46 crores in 1954-55 and between June 1954 and July, 1955, increased by Rs. 43 crores, from Rs. 347 to Rs. 390 crores.

1. Ibid P. 343
Part of this, however, indicates the purchase of treasury bills, but even so, this seems to be a high rate of increase. With considerable expansion of the commercial banking system, in the subsequent years, the banks will be able to invest additional funds in government securities.

But there should be a limitation of holding government bonds by the banking system in the portfolio. If the banks hold government bonds, then, of course, the demand deposits are automatically created. The Banking System can create additional credit by selling, in the open market, the government securities or by borrowing from the central bank against them and as such, inflationary forces may work out unless the monetary authority exercises any control over such expansion. In an under-developed country like India, the Reserve Bank of India cannot refuse to support the government security market if the government wants to raise fund through public debt for development expenditure. The market for the government securities can be built up only if the investors are assured of the fact that they will not suffer as a result of the fall in prices of securities held by them. If the Reserve Bank of India does not support the government security market in the face of a concentrated sale of the government bonds by the banking system, the genuine investors will not be encouraged to invest in them unless the government makes the subscription to government loans compulsory. Hence the Reserve Bank may face the dilemma between the objective of credit control and that of the stabilization of the prices of government securities. Therefore, the ownership of government bonds by the commercial banks should be limited. Moreover, the Reserve Bank
should raise the reserve requirements on demand deposits to control the access of the banking system to additional reserves when the banks attempt to expand credit by using their excess reserves.

**INSURANCE AND OTHER INSTITUTIONAL INVESTORS:**

Other institutional investors like insurance companies, investment trusts, saving banks, and joint stock companies other than banking companies which do not generally liquidate the loans before their maturity, should be encouraged to invest in Government bonds. As life insurance in India has been nationalised, a maximum support to Government loans is assured. In 1954, the total assets of life insurance companies amounted to Rs.301 crores, of which Rs. 146.29 crores was invested in central and the state-government-securities. In 1955, the estimate of insurance assets would amount to Rs. 360 crores of which an amount higher than that of the previous year must have been invested in government-securities. With life insurance nationalised, if the progress of the last two or three years is maintained, which is quite possible under the state-control, the funds will be available at the disposal of the State-Controlled Insurance Corporation to invest in government-securities leaving a small margin for working fund. The nationalisation of life insurance is a right step in the direction of more effective mobilization of public loans.

Indian joint stock companies are also important subscribers to public loans. The Reserve Bank of India pointed out that investment of 771 companies in government securities were Rs. 20.65 crores in 1951, Rs. 21.87 crores in 1952, and Rs. 23 crores in 1953. Though figures for 1954 and 1955 are not just now available, it may be assumed that investments of Indian joint stock companies in

1. Ibid P.P. 149 and 150
2. The Reserve Bank of India Bulletin, April, 1956, P. 361.
government-securities were in the same proportion as in the previous years. With the increased tempo of economic development in the second plan-period, Indian joint stock-companies will gain greater profits, and their subscription to public loans is likely to increase even after taking into consideration their own increased business investments. With the increase in income of the people, the subscription of other investors to public loans will also rise. The facts stated above will amply prove that the rising of the funds to the tune of Rs. 700 crores through public borrowing is not impossible.

When the growing public borrowing weakens the position of the monetary authority by making the instruments of credit-control ineffective to check the growing inflationary pressure resulting from expansion of credit, in planning the public debt, care should be taken to equip the monetary authorities with some effective monetary weapons. 1

TAXATION AS A MEANS FOR FINANCING THE DEVELOPMENT-EXPENDITURE:

When the economic development of a backward country is undertaken, taxation offers itself as one of the methods of raising the finance for meeting the development-expenditure. In the modern days, as the state is one of the important agencies undertaking developmental investment, taxation must bulk large in the fiscal programme of the underdeveloped areas. 2

It has been stated before that, in India, Rs. 350 crores from current revenues at the existing rates and Rs. 450 crores from additional would be available for financing the plan in the public sector. The draft outline of the Second Five Year Plan and the discussion preceding it focussed a large number of suggestions

1. Dr. D. R. Khatkhate- Problems of monetary policy in a developing economy. P. 211 (2) Ibid. P. 212.
regarding taxation. In this connection, it is worthwhile to consider the recommendations of the Taxation Enquiry Commission appointed in April, 1953.

According to the opinion of the Commission, ways and means should be devised to ensure simultaneous progress in the directions of greater production and better distribution of income and wealth. In order to speed up economic development, efforts should be made to cover as large a part of the government's outlay as possible through increase in both direct and indirect taxation. Therefore, there should be taxation of a wide range of luxury and semi-luxury products at fairly substantial rates and broad-based taxation of articles of mass consumption at comparatively low rates. As between direct and indirect taxes, in the opinion of the Commission indirect taxes especially may have to play an increasingly important role in finding resources for the plan. In an underdeveloped country like India, taxes amount to 7 or 8 percent of the national income. Since the contribution from direct taxes is insignificant, the Commission feels that more reliance has to be placed on indirect taxes or commodity taxes in order to implement the economic development-programme. If the people desire to have a better economic life, they should, of course, make some amount of sacrifice in consumption. But indirect taxes are always regressive. If commodities of mass consumption are taxed, in India, the common people whose consumption-standard is low will be driven to a still lower standard of living.

2. Ibid. P. 149.
3. Ibid. P. 155.
Therefore, the commission's recommendations for steeper progression in income tax, enhancement of estate duties and the levy of tax on wealth and capital gains, seem to be reasonable. This policy will reduce inequality of income and at the same time will increase government revenues for the development-expenditure. In order to encourage industrial investment in the private sector, the commission recommends certain tax concessions on specified lines of production. For instance, some reduction in the corporation tax, right to carry forward losses indefinitely, no taxation of bonus shares, additional depreciation on undistributed profits are some of its suggestions.

The Budget for the year 1956-57 was an important budget in the sense that the changes in the taxation proposals in it were particularly on the lines recommended by the Taxation Enquiry Commission. Although the main objective was, of course, the to raise additional revenue for development purposes, several other objectives (such as the reducing of inequalities in income by raising taxation at the higher income level and the increasing of the taxation allowance at the bottom, the offering of incentives to savings and investments by such concessions as development rebates) were also sought to be achieved by suitable adjustments. Similarly the budget of for 1956-57, the first year budget of the Second-Five-Year-Plan period, has been framed more or less on the same lines.

A section of the non-official circles sharply criticised the recommendations of the Taxation Enquiry Commission regarding the changes in the taxation proposals. According to them the objective of reducing inequality of income by steeper progression in income tax, enhancement of estate duties and the levy of annual tax on wealth.
is likely to conflict with the promotion of incentives to productive enterprises. They argue that increase in production is often accompanied by greater economic inequality. Inequality of income is regarded as economically necessary to evoke additional effort or enterprise. Further steepening of the progression in income tax and the fixing of a ceiling on personal incomes after a certain limit, in their opinion, are not only impracticable but also disastrous.

The concept that increase in production is often accompanied by greater economic inequality, might have been historically true in the nineteenth century when political democracy was in its infancy and the concept of the welfare state did not take any shape. Political and economic conditions are not quite different. Hence the problem of equality cannot be left to the "automatic functioning of economic and social forces". Ways and means should be devised to ensure simultaneous progress in the directions of greater production and of better distribution of wealth. This is in keeping with objective of the Directive Principles of the Indian Constitution. Article 39 states that one of the ideas of the state policy should be to ensure equitable distribution of the material resources of the Community and to prevent concentration of wealth and means of production.

An increase in direct taxation, of course, reduces private consumption and investment, but that does not imply that taxation, even at higher rates reduces investment in the aggregate, as the proceeds of taxation are, however, available to the public sector for investment.

1. The Statesman: June 27, 1956, Second Five Year Plan Supplement, P. 2
The contention that, for financing capital expenditures, there is no justification for burdening through taxation the present generation with the whole cost of development-programmes intended to benefit future generations, seems to be erroneous. The commission's argument against appears to be very reasonable and convincing. The question of the relative use of taxation and borrowing relates to the appropriate method of meeting, in the present, the cost of investment-programme. There is, therefore, little substance in assuming that a part of the current cost of development can be shifted to posterity. There is no way of securing the postponement of the cost, in terms of resources, of a large investment programme; the programme involves a deduction, here and now, from the resources available to the community for current consumption.

On the question of deficit financing which will be discussed later on, the Taxation Enquiry Commission sounded a note of warning about its use as a means of development finance. In an underdeveloped country like India which is capital-deficient and where the time-lag between credit creation and flow of essential goods is much longer and output smaller than in the industrially advanced countries, from the long-term point of view, deficit financing plays quantitatively an insignificant part. Because of this limitation, the commission strongly favours the need of enlarging the rate of taxation and borrowing.

1. Ibid, P. 153.
in the financing of the development-programme of the public sector.

The Panel of Economists also stressed the need for full and speedy implementation of the recommendation of the Taxation Enquiry Commission for mobilising the resources needed for development. The Panel is of opinion that something like 9 percent of national income should be directed into the national fix in the form of total taxation if deficit financing is to be kept within safe limits. Therefore, in their opinion, "the measures recommend by the Taxation Enquiry Commission for a widening and deepening of the tax-structure have to be implemented expeditiously and tax administration has to be strengthened to enable it to cope with the additional work and effectively to minimise evasion".

Prof. Kaldor's proposal on taxation: Mr. Nicholas Kaldor, a well-known British economist, who came recently to India on the invitation of the Government of India disagreed with the Planning Commission that the Indian economy would be capable of absorbing Rs. 1200 crores of deficit financing as proposed in the plan. If the targets of the Second Plan are to be achieved, the additional taxation required should be, in his opinion, Rs. 1250 crores in five years, that is Rs. 250 crores a year.

According to him, Rs. 1250 crores can be raised by way of additional taxation provided "the problem is tackled on bold lines and the tax system subjected to a thorough and comprehensive reform".

Mr. Kaldor is of opinion that a large portion of the amount should be raised by direct taxation, what he calls personal...

1. Papers relating to the Formulation of the Second Five Year Plan - Panel of Economists, P. 3
2. Ibid, P. 4.
3. Kaldor's Report-Issued by the Department of Economic Affairs-Ministry of Finance, Govt. of India.
He suggests four kinds of direct taxes, such as, an annual tax on capital gains, a general gift tax, and a personal expenditure tax. He feels that the maximum rate of income tax should not exceed 45 percent. He claims that his proposal, if accepted, would not only bring down deficit-financing from Rs. 1200 crores to the safe limit of Rs. 800 crores but also bridge the uncovered gap of Rs. 400 crores in the plan.

The present system of direct taxation, according to him, is both inefficient and inequitable. It is inequitable because the base of taxation is defective and is capable of being manipulated by certain classes of tax-payers. It is inefficient because tax evasion on a large scale is prevalent in India furnished by tax-payers and the absence of any comprehensive reporting system on property transactions and property-income. Mr. Kaldor claims that the taxes proposed by him aim at the elimination of, or at least a considerable reduction in the scope of tax-evasion through the institution of a comprehensive return and the introduction of a comprehensive reporting system on all property transfers and other transactions of a capital nature.

Excise duties on a limited number of commodities of mass consumption "should be regarded as the marginal source of taxation to be resorted to only, when, and to that extent that, the total yield from direct taxes falls short of requirements".

Mr. Kaldor's emphasis on direct taxation has been strongly opposed by many in both the non-official and the official circles. The government of India also have the least eagerness to accept
his proposal. The unequivocal expression of Mr. C. D. Deshmukh, the then Finance Minister of the Government of India, in favour of raising the bulk of his revenue from excise clearly indicates that he wanted to adhere strictly to the recommendations of the Taxation Enquiry Commission, according to which "some contribution must come from the masses of the population through taxes which have a wide base." 1

From the revenue point of view, emphasis of the Taxation Enquiry Commission and of the Panel of Economists more on indirect than direct taxation may seem to be reasonable. It might be administratively simpler to collect revenue by taxes on transactions, such as, sales taxes, excise duties etc or adrem taxes of various kinds, rather than by taxes levied on persons assessed according to some overall criterion of ability to pay on a graduated scale. But, in a developing economy where private wealth grows rapidly and unevenly, it becomes socially intolerable if the burden of taxation falls heavily on the broad masses of population. The common people should of course, be prepared to make some sacrifices from their consumption for the implementation of the economic development programme in the country. But, as their consumption standard is on the subsistence level, the burden of taxation to be borne by the common people should be the minimum possible.

Mr. Kaldor's argument that direct taxation should play a more important part than indirect taxation in raising the fund for the development expenditure seems to be quite reasonable. It is but fair that the maximum burden of taxation should be borne by those who are rich.

And excise duties on a limited number of commodities should be regarded as the marginal source of taxation. His taxation proposal should receive careful consideration at the Government level in order to minimize deficit for financing to the safest limit.

**NEED FOR FOREIGN CAPITAL:**

As the total development expenditure cannot be met from the domestic capital sources, the need for foreign capital is obvious in an underdeveloped country like India. Like other underdeveloped countries, India is faced with a choice between minimum consumption standard and capital accumulation realised through more savings. It will be a great hardship for the common people to reduce their consumptions which are already low so the scope of capital accumulation is limited. In order to force the pace of its economic development, India requires capital-goods to be imported from abroad. If domestic savings are utilised for producing capital-goods, development will be a time-consuming process involving a lot of sacrifices. Therefore, the need for foreign capital is all the more imperative as foreign exchange is made available through it for importing capital goods.

As the balance of payments position is not likely to improve as a result of the increase in competition in some export items in the Second-Five-Year-Plan period, import of foreign capital cannot be avoided for accelerating the pace of economic development in our country. In the original estimate of the draft plan-frame, Rs. 400 crores were regarded as the probable amount required as external

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assistance. Later on, the Panel of Economists estimated that foreign assistance to the tune of over Rs. 600 crores would be required for the plan period if a drainage of foreign exchange was to be avoided. The Planning Commission finally decided that an assistance of Rs. 800 crores would be required to meet the heavy strain on the balance of payments resulting from an increase in imports of capital goods.

The availability of this estimated amount from abroad will depend upon political and international factors. In whatever form—direct investments, loans or grants—foreign assistance is received, the use of it should be free from political and economic strings by the capital-exporting countries. Foreign loans, whether direct, inter-government or international, should be available on liberal terms in interest rates and the period of maturity for repayment.

**A CASE FOR MULTIPLE EXCHANGE RATES:**

As the receipt of foreign capital depends upon non-economic factors, it is essential for India to conserve foreign exchanges to import capital goods for her economic development for which multiple import rates can be used as a policy, a preferential rate being applicable to imports of capital equipments and other essential goods, and higher rates to luxury and non-essential imports. When a country finds that its aggregate demand for imports exceeds the foreign exchange receipts available to pay for them, the tendency to use differential import rates to encourage some essential imports and to discourage other nonessentials, is witnessed in many

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countries as part of a thorough going programme of economic development or of redistribution of real income. In the period following the Korean War, for instance, Thailand and Indonesia relied on multiple import-exchange-rates for regulating commercial imports. During 1953, the number of commodities eligible for obtaining foreign exchange at preferential rates was progressively reduced and the supply of foreign exchange by the Bank of Thailand to the commercial banks was also curtailed. In September 1953 import duties were increased on certain non-essential commodities. The Latin American countries, namely, Columbia, Ecuador, Paraguay and Chile used differential import rates for the conservation of foreign exchange in their respective countries.

India will do well to adopt an identical policy to conserve sufficient foreign exchange for the procurement of capital goods necessary for her economic development.

It may be argued that when demand for imports arises owing to the generation of inflationary forces, (at least under present conditions in India) multiple import-rates should not be used because of their adverse effects on the cost of living. But priority should be given to maintain foreign exchange reserve for economic development, even if the consumers of luxury and non-essential imported goods are required to pay high prices. Price-controls and rationing should be introduced when prices of goods domestically produced rise high owing to inflationary pressure.

Recourse to deficit financing can be had when the receipts from other sources prove inadequate to finance the plan. Deficit financing by the creation of extra money leads more or less automatically to an expansion of bank credit due to the rising demand for credit. In India, the Planning Commission visualised deficit financing to the extent of Rs. 1200 crores. Accordingly, in order to enable the Reserve Bank of India to issue more notes than before, the Reserve Bank of India Act was amended in July 1956. India's Currency system has been changed from a proportional to a fixed minimum reserve system. The minimum limit has been put at a fairly low level amounting to Rs. 115 crores of gold and Rs. 400 crores of foreign exchange. To bring the supply of gold to a minimum level, the gold already held by the Reserve Bank of India, has been revalued at 2.88 grains of fine gold per rupee as against the present valuation at the rate of 8.47512 grains recently approved by the International Monetary Fund.

In India, the term deficit financing has not been used in the Western sense of loan financing of the deficit, but it has been used in the sense of covering overall budget deficits by drawing down the cash balances of the government or by borrowing from the Reserve Bank. Borrowing from the Central Bank or utilisation of cash balance does not lead to a direct transfer of purchasing power from the public to the government. Government expenditure financed by such means simply adds to the existing effective demand. Cash reserves of commercial banks increase rapidly.
As a result of the increased liquidity of the banking system, the banks can expand additional credit for private investment thus enhancing the effective demand all the more. Unless consumption-goods are produced or imported quickly in a sufficient quantity, the impact of deficit-financing will be inflationary.

In underdeveloped countries the ratio of production to capital investment in industries, both primary and secondary, is comparatively low owing to so many difficulties, such as, irregular and short supply of raw materials, lack of equipments and trained personnel, transport difficulty and other organisational deficiencies, etc. Consequently, the supply-curve of the aggregate output is inelastic. As the excess productive capacity of industries is small in the backward countries, investment in factory industries involves usually a longer interval between the capital-investment and the increase of production.

As such financing of development expenditure by borrowing from the central bank or drawing down the cash-balance of the government, generates inflationary forces in the under-developed countries, because of the disproportionate ratio between of the money-income of the public and the aggregate output. In India because of the above stated impediments in industries the time-lag between investment and production is fairly long and the output-capital-ratio is low. The pattern of investment visualised for the plan, indicates that the major part of the total investment will be allotted to heavy industries in one form or other and to transport which will yield output at some later date. This implies a slow growth in the supply of consumer-goods.

In the context of these facts, it is clear that in the future, the supply of consumer goods will be inadequate in relation to demand. Consequently, the inflationary pressure will last for a long period unless various economic controls are introduced.

Therefore, deficit financing through borrowing from the Reserve Bank of India, by drawing down the cash balances of the government and by issuing currency by the Reserve Bank against adhoc treasury bills has the danger of an inflationary impact. The Panel of Economists cautioned all concerned "against any tendency to undue optimism as regards the extent to which the use of deficit financing may avoid the awkward necessity of deliberate endeavour to mobilise resources." 1

Deficit financing under the state of inflationary pressure should, therefore, be resorted to with due reserve. In India, inflationary forces have been in operation since June, 1955. Between June, 1955 and August, 1956, the price of food articles rose from 276.7 to 397.7, raw materials from 386.2 to 497.4, semi-manufactures from 330.9 to 406.0 and manufactures from 371.0 to 387.2. The price of all commodities rose from 340.6 to 417.9 i.e., by 77.3 points. Between May 1955 and August 1956 the general price-level went up by 82.7 points. There was during this period a substantial expansion of money-supply with the public. This is in turn mainly due to the budgetary deficit of the government and extension of credit by banks. If prices soar in this way, there will be no end of inflation. Nothing perhaps makes the life of the common man more miserable than inflation.

1. Report of the Panel of Economists. P. 4
According to the Planning Commission, "the scope for" deficit financing at any particular time rests on the trends in the cost of living indices. The present-day price situation in India clearly indicates that a further dose of deficit financing will let loose a process of run-away inflation. Because, as the cost of living is already high, increased purchasing power injected into the system will push up the cost of living still further.

If inflation is reckoned as certain as a result of the deficit financing to the tune of Rs. 1200 crores in the Second-Five-Year-Plan period, the question arises as to what measures should be adopted to check it. Like Prof. B. R. Shenoy, should we think that the size of the Plan should be curtailed and adjusted to the available financial resources? This step will, of course, mean that all the targets of the plan have to be drastically reduced. For obviously, there can be no drawing back now from the level of investment accepted for the Second Plan and there can be no reduction in the size of the plan. The orthodox view of Prof. Shenoy that the community cannot progress faster than the rate of savings is a most point in the present day economy.

Like the classical economists, Prof. Shenoy possibly believes that the economic progress depends on the increase of savings that arise out of reduced consumption. This view of the classicalists has been refuted by Keynes and other economists. According to them, the decreased consumption, instead of promoting the economic progress will retard it-by removing a very essential motive force of the economic activity.

1. First-Five-Year-Plan, P. 61.
2. Note of Dissent by Prof. B. R. Shenoy, Papers relating to the formulation of the Second-Five-Year-Plan, P. 19 to 32.
   H Moulton-Formation of capital.
Savings, in their opinion, can be augmented through the increase of production without adversely affecting the consumption. Unlike the classical economists who regarded money as neutral agent, they have argued that money is not only a medium of exchange but can also be used as a factor of production. Therefore, by financing with new money and through extension of credit, the monetary authority can bring about the development of economic resources. But owing to the unresponsiveness and inelasticity of the productive system in the underdeveloped countries, financing of development expenditure by new money and credit has the danger of inflationary pressures.

In India, in that case, financing of the development expenditure of the Second Five-Year Plan with new money and expanded credit should be made with due care.

**NEED FOR MONETARY MEASURES:**

As the power of commercial banks to create credit will increase owing to deficit financing, the use of fiscal and monetary measures has been thought of and given a high place in India, in the anti-inflationary set-up of the future. Besides the employment of quantitative credit control techniques in the shape of the bank rate and the open market operation, the Reserve Bank of India is empowered under the Reserve Bank of India Amendment Act of 1956, to use the variable reserve ratios to control the inflationary expansion of credit by commercial banks.

The system of the variable reserve ratios has been regarded, in the recent years, as recognised means of central bank control over bank credit in many developed and under-developed countries.
Although this technique of credit control was first introduced in the United States of America in 1933, provisions have been made in recent years in most of the central bank statutes of undeveloped countries empowering the central banks to change the reserve requirements within a broad range of 10 to 50 percent in order to fight inflationary and, if necessary, deflationary pressures.

Under the new statute, the existing statutory reserve amounting to 5 percent of demand deposits and 2 percent of time deposits as maintained by the scheduled banks with the Reserve Bank of India will continue; but the Reserve Bank is vested with the power to vary reserve requirements of the scheduled banks within the range of 5 to 20 percent in respect of demand deposits and 2 to 8 percent in respect of time deposits.

One of the defects of the variable reserve ratio in its traditional form is that it is discriminatory in its effect as it affects different banks differently. Banks with a small margin of excess reserves will be more hard hit than banks with a large margin. In India, this defect is removed by the new law as the scheduled banks will be required to maintain additional reserves with the Reserve Bank of India in respect of any increase in deposits after a specified date. This is intended to enable the Reserve Bank to mop up, if necessary, the entire increase of bank deposits with a view to arresting further expansion of bank credit.

The Federation of Chamber of Commerce and Industry objected to it on the ground that the exercise of this power by the Reserve Bank might discriminate against those banks which showed greater
initiative and enterprise and succeeded in increasing their deposits as compared to others. The argument of the Federation seems to be unconvincing because of the great potentiality of these banks to expand credit resulting in inflationary pressures.

Another defect of the system is that a sudden increase of the Reserve ratios by the monetary authority may produce a depressing effect upon the government security market. If the ratios are raised, as Keynes suggested, with due notice and in small degrees, undesirable psychological reactions can be avoided. In many underdeveloped countries, such as the Philippines, Ceylon and Guatemala, provisions have been made to raise the reserve ratios with due notice and "in a gradual and progressive manner". Dr. S. K. Basu's proposal for similar provision in the system of the flexible reserve requirements in the case of India seems to be very reasonable because, buoyancy of the government-security-market should be maintained if the government borrowing under the Second-Five-Year Plan is to be carried out.

The open market operation and the variable reserve ratio as suggested by Whittlesey in the recent years, may be jointly applied in order to remove defects attached to each instrument of credit control. If the Government-security-market is demoralised as a result of the increase in reserve requirements, the Reserve Bank of India may adopt the open market purchase policy only to that extent which will support the prices of a security in the market.

1. Letter dated 1st June, 1956 of the Federation of Indian Chambers of Commerce and Industry to the Finance Secretary to the Government of India, Ministry of Finance, reproduced in circular letter no. 91 dated the 9th June of India Banks Association.


In underdeveloped money markets, ordinary banks are generally accustomed to maintain highly flexible reserve ratios for which the variable reserve system is rendered a crude and insensitive weapon of credit control. In India from 1938-39 to 1953-54, the average ratios (cash and balances with the Reserve Bank of India as percentages of total liabilities) maintained by the scheduled banks fluctuated between 9.80 percent and 17.14 p.c. In recent years, however, there were limited variations in reserve ratios in India. The more rigid the reserve ratios are, the more effective will be the variable reserve ratio as a technique of credit control. Therefore, what is in India is to maintain the rigidity of the Reserve ratio for the effective application of this technique.

**BANK RATE AND OPEN MARKET-OPERATION:**

The other two traditional weapons of quantitative credit control, such as the bank rate and the open market operation which were potent force for controlling credit, till the First World War, have lost now much of their importance. Even in economically advanced countries like the United Kingdom, and other continental countries, where money and capital markets are well organised, they have limited significance.

Since the inter-war depression, attempts were made to regulate the economic activity by manipulation of interest rates. The challenge of depression was met by a vigorous policy of cheap money in the United States of America and in many countries of Europe. But the response was disappointing.

1. A. F. Plumptre- Central Banking in the Dominions. P. 278.
In the post-war years, when uninterrupted expansion of credit and an unsteady boom threatened another collapse, clear money was applied. Again success was limited. To take the very recent experience, the bank rate ruling at 5½ percent, in the United Kingdom, failed to hold down prices and to correct the adverse balance of payments position.

In an underdeveloped country like India where wide section of banking business is separated from the organised banking system, a higher bank rate has more limited scope than what it has in developed countries. Similarly, in a narrow and undeveloped capital market alike that in India, suspension of open market purchase or sale of the government securities in the open market might cause a rapid fall in the prices of the Government bonds resulting in a collapse of the government security market.

As the central banks of the Phillipines and Paraguay have been authorised to carry on the open market operations using their own securities, when necessary, to prevent the collapse of the government security market and to strengthen their anti-inflationary actions, the Reserve Bank of India should be empowered to adopt similar measures to fight the threat of inflation in the Second Five Year Plan period.

In important lacuna in the use of the techniques of quantitative credit control is that all investments whether essential or non-essential are uniformly affected by these instruments when they are used. The economic growth of an underdeveloped country is likely to be retarded if essential investments are discouraged by restricting credit.

It can be, no doubt, possible to restore the equilibrium in the balance of payments position and to check the inflationary tendency by using the techniques of quantitative control but they will be achieved at the cost of capital formation.  

NEED FOR THE USE OF THE INSTRUMENTS OF SELECTIVE CREDIT CONTROL:

In order to promote productive capacity through essential investments and to maintain the equilibrium in the balance of payments-position, what is needed for the monetary authority is to use the instruments of selective credit control instead of using the traditional techniques. The instruments of selective control are used to restrain credit in particular economic sectors or areas, when inflationary tendencies or speculative excesses are noticed in those sectors or areas. They prescribe the terms on which certain kinds of loans or credits may be granted regardless of whether the banks have adequate or limited reserves.

In many economically advanced countries they were used extensively as supplementary to quantitative controls in the post-war periods. For instance, in the U. S. A., the Board of Governors of the Federal Reserve System raised the margin requirements to 100 percent in January, 1946 for the purpose of checking the strong inflationary pressures and the speculative excesses on the stock exchange-market. Selective controls, in the shape of consumer and real estate-credits, were adopted to curb the use of credit for the purchase of consumer's goods and services in the former case and

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1. Dr. D. R. Khatekhate- Problems of Monetary Policy in a Developing Economy. P. 137.
and for constructing, purchasing and financing new houses in the latter. In the United Kingdom the banks were required to follow the directives issued by the Capital Issue Committee in respect of their lending policy and also the instructions issued by the Bank of England from time to time regarding the priorities to be given to different uses of the banking advances. Similarly, selective credit control measures were taken also in the Western European countries to combat inflation in the post-war years.

It is remarkable to note that in many underdeveloped countries like Guatemala, Paraguay, the Phillipines, Ceylon, Burma, Pakistan etc, the central banks have been endowed with new and powerful techniques of selective credit control.

The central banks, in those countries, have powers to regulate credit by fixing the maximum rates of interest which banks may charge for different types of loans, setting permissible maturities for banks loans and investments and indicating the type and amount of security to be required. They can prescribe the minimum cash margins for opening letters of credit and an upper limit on the total loans or investments a bank may hold in the aggregate or by specific categories, and can require observance of minimum ratios of capital and reserves to the volume of their assets.

In India, regulation of credit, through selective controls, was not given much importance. The Reserve Bank of India has not yet been endowed with more instruments of selective controls except

1. Chapter V, PP. 131 to 144 of this book.
2. Ibid Chapter VI, PP. 170-171.
3. Ibid Chapter VII, of this book.
4. Ibid Chapter VIII.
that the Bank is allowed, under section 21 of the Banking Companies Act of 1949, to determine the policies, to be followed by banks generally or by individual banks, in relation to advances to be made. The Act authorises the Reserve Bank to determine the purposes for which advances may or may not be made, the margins to be maintained with respect to secured advances and the rates of interest which may be changed by the banks on them. The recent measures taken by the Reserve Bank of India over the scheduled Banks' advances against paddy, rice, wheat, cotton-piece-goods and yarn, with a view to discouraging hoarding and speculative dealings in these commodities, indicate that the Reserve Bank is quite conscious of the situation and of the necessity of employing methods of selective controls.

In the current financial year of 1956-57, the Reserve Bank of India issued directives to the scheduled banks requiring them not to make advances to any particular client of more than Rs. 50,000 only against paddy, rice or wheat including jowar, bajra and maize and the margins on the advances against them to be raised by 10 percent. It also demanded fortnightly statements from the scheduled banks about their advances.

By another circular letter, the Reserve Bank directed the scheduled banks to raise the margins by 10 percent on advances against cotton-textiles and yarn and to submit fortnightly returns about their advances. These measures taken by the Reserve Bank of India are, no doubt in the right direction to combat the potential threat of inflation, but they are not enough. Considering

the potentiality of inflation under the impact of deficit financing in the Second Five Year Plan period, the Reserve Bank should be armed with new and powerful instruments of selective controls more or less on the same lines adopted in other countries. Because the problem of an underdeveloped country like India which is in the phase of economic growth, is not so much to bring down the total investment expenditure that is inflationary, as to check useless expenditure and to encourage developmental outlay.

**NEED FOR PHYSICAL CONTROLS:**

Historical experience justifies that monetary measures by themselves alone are ineffective to control inflationary pressures. High rates of interest for instance, in the U.S.A. failed to check the inflationary movement of prices in 1919-20 or the speculative tendencies in the real estate and security-market in the late 1920s. In the years following the World-War II, monetary measures played a limited significant role in checking inflation in many industrially advanced and underdeveloped countries.1

Against the background of the threat of the inflationary tendency in the Second 5 Plan period, the economy of India which is on its way to development, may suffer from bottlenecks in many directions and from serious shortage of essential materials needed for the consumption and productive purposes. In order to check the inflationary pressure arising out of deficit financing and to meet with the shortage of essential materials, physical controls,"in a more direct manner", as Prof. D.R. Gadgil puts it, may be needed. The checking of the rise in prices and

1. Discussed already in chapters from V to X in this book.
allocation of materials in productive channels can be effectively directed by a skilful use of controls and rationing with a high degree of administrative efficiency.

In conclusion a rational fiscal-and-monetary policy, consistent with the size and structure of the plan, and the growing importance of the public sector and the financial implication involved therein, is a sine qua non of economic progress, against the background of the inflationary pressure under the impact of deficit financing with the objective of building a socialistic pattern of society under the mixed economy principles envisaged in the Second-Five-Year-Plan of India.