CHAPTER-2

FISCAL POLICY- AN OVERVIEW
2.1 Meaning and Objectives of Fiscal Policy:

Fiscus (in Latin) refers to a purse and ‘fisc’ (in English) is a royal or state treasury. Mrs. Hicks says that fiscal policy is concerned with the manner in which all the different elements of public finance, while still primarily concerned with carrying out their duties (as the first duty of tax is to raise revenue), may collectively be geared to forward the aims of the economic policy (Hicks, U.K., 1968). The crux of a good and effective fiscal policy lies in keeping its ingredients like expenditure, loans, transfers, tax revenues, income from property, debt management, and the like in a proper balance so as to achieve the best possible results in terms of the desired economic objectives. Usefulness of fiscal policy lies only if it facilitates in achieving socio-economic objectives of the society. But it must not be forgotten that fiscal policy is only one of the many sets of weapons in the hands of the Government. It should also be emphasized that fiscal policy tries to achieve its objectives by regulating the working of market mechanism (while in contrast some other weapons may by-pass it). The extent of its success, therefore, largely depends upon the response of market forces to various policy steps initiated by the Government. The fact that fiscal policy can be a potent tool in the hands of the authorities came to be recognized only slowly. For decades, both official and academic thinking favored laissez-faire and balanced budgets. This policy, obviously, had its own drawbacks. As Keynes pointed out, an attempt to balance the budget results in its imbalance and vice versa. In spite of these problems, the appropriateness and usefulness of fiscal policy came to be recognized only during 1930s and later. The significance of fiscal policy as an instrument of economic control was first emphasized in the mid-1930s by Keynes' *General Theory of Employment, Interest and Money*. Keynes showed clearly the direct and indirect effects of fiscal action on aggregate spending in the community and its influence on economic activity and gave a new importance to the budgetary policy of the Government as a weapon of economic management.

Fiscal policy has three important tools: taxation, public expenditure, and public debt management. The tax system of the country, of course, is meant to bring in revenue to the Government but it can also be used to encourage or restrict private expenditure on consumption and investment. Public expenditure of the Government
may take various forms-normal government expenditure (on civil administration, defence, etc.), expenditure on public works (such as road, parks, etc.), expenditure on relief works, subsidies of various types, etc., while taxes reduce the income of the general public (they transfer income from the general public to the Government), public expenditure transfers income from the Government to the general public. Finally, Government borrowings and public debt influence the volume of liquid assets with the public, for example, subscription to a Government loan would transfer liquid funds from the general public to the Government, while repayment of a public debt would mean transfer of funds from the Government to the general public.

All these three tools of fiscal policy- tax policy, public expenditure, and public debt management- are significant to maintain economic stability and for influencing the level of economic activity. It is now generally accepted that the main problem of industrial or high income economies is stability in business conditions and maintaining full employment, while rapid economic progress and increase in employment are the basic needs of less developed countries. Fiscal policy has come to assume significance as effective means of stabilization in an advanced economy and, therefore, for high income countries. It is now generally held that no other measure of economic planning is better than adoption of a correct fiscal policy. Some fiscal theorists argue that fiscal policy may not be effective in an underdeveloped economy, since modern economic and financial institutions are not as well developed. Even then, fiscal policy has a positive and significant role to play in an underdeveloped economy. In the first instance, the state is called upon to play an active and important role in promoting economic development, especially through control and regulation of economic life; it is argued that fiscal policy is the most powerful and the least undesirable weapon of control which the state can employ to promote economic development. Secondly, capital accumulation is the key problem of an underdeveloped economy and this can be done through taxation. Finally, fiscal policy has an important role to play under democratic planning; financial plan is as much important as physical plan and the implementation of the financial plan will obviously depend upon the use of fiscal measures.

Fiscal policy may be taken to embrace all government transactions which have as their objective the support of general economic policy. In an advanced country (atleast of the welfare state type) general economic, as distinct from political, policy is
distribution of available (spendable) incomes. In an advanced country fiscal policy very largely operates on the expenditure side of the account, through widespread social expenditure and through selective incentives directed to particular industries or localities which it is desired to encourage. These are both long term fields of operation. Expenditure policy is also extremely important in respect of short-term stability (compensatory finance), because of the ease with which alterations can be brought about in social expenditure, or, more precisely, in the balance between social expenditure and social taxation (insurance contributions). Main reliance for income redistribution falls, however, on the tax side of the account. By controlling the available incomes of the rich and by redistributing capital assets through taxation a far greater equality of spending power is obtained than results from the productive process. Increasingly also, on the side of production, attempts are made to write into tax formulae (especially of profits taxes) incentives for investment, both general and selective. These too can be varied over time in the interests of stability. Thus, fiscal policy in an advanced country comprises a large supply/armoury of weapons, some concentrating mainly on welfare effects, others on considerations of economic growth with stability; some aiming mainly at short-term effects, others at long-term development. But no means all these objectives are consistent. For instance redistribution carried out too violently, or a stability policy which reaches the point of long-term disincentive, are both inimical to growth. Subsidies to certain industries (particularly to agriculture, which are the most general) may counteract an income redistribution policy by forcing consumers to pay more for their food, thus injuring the poor more than the rich. In a developing country the main emphasis of general economic policy will be on growth, with sufficient stability to prevent recurrent crises which would cause development to slow up or even retrogress, and hence give rise to losses on investments already made. With different emphasis in different countries, it will probably also be desired to use fiscal policy to reduce the very large gap between the incomes of the few rich and many poor. On the expenditure side there is not likely to be a great deal of opportunity for a policy either of income distribution through social expenditure or of stabilization through compensatory variations in public outlay. In all lines of expenditure growth must have the priority. Hence, the heaviest responsibility both for stability and for income redistribution must fall on the tax side of the account (Hicks, U.K., 1965)\(^2\).
The chief objective of the fiscal policy in the developed countries is to counteract cyclical fluctuations arising out of the dips and spurts in the level of aggregate effective demand. As such the Keynesian fiscal recommendations hinged on the ways to regulate the level of aggregate effective demand and the total flows of purchasing powers are well suited to the needs of these economies. But growth being the primary goal of the underdeveloped countries, the fiscal policy in their case has to be tailored to the needs of rapid economic growth. Further, the very fact that these countries have a low propensity to save and a high propensity to consume, an inversion of Keynesian fiscal measures is called for in their case. Thus, whereas the maintenance of stability is the key-note of fiscal policy in developed countries, and this key-note of the fiscal policy in underdeveloped countries has to be the fostering of an accelerated rate of economic growth.

Fiscal policy seeks to influence the economy through a double-barreled course; by the magnitude of public income that could be raised, and by the volume and direction of the public expenditure. The latter, of course, to large extent depends on the former. The magnitude of fiscal revenue pre-eminently determines the availability of resources with the government to finance economic development. The government has access to three important fiscal means through which resources can be raised, viz., taxation, public borrowing and credit creation. A successful operation of the fiscal policy requires a harmonious combination of these three means. Only then it can engender rapid economic growth with stability. However, taxation remains the most effective instrument of fiscal policy. As such, the actual efficiency of fiscal policy largely depends on the country’s tax system. Within the framework of general programme for accelerated development, fiscal policy in general and taxation policy in particular should be so attuned and used as to accomplish the following main objectives of developing countries:

i. **Mobilization of resources**: Developing economies are characterized by low levels of income and investment, which are linked in a vicious circle. This can be successfully broken by mobilizing resources for investment energetically.

ii. **Acceleration of economic growth**: The government has not only to mobilize more resources for investment, but also to direct the resources to those channels where the yield is higher and the goods produced are socially accepted.
iii. Minimization of the inequalities of income and wealth: Fiscal tools can be used to bring about the redistribution of income in favor of the poor by spending revenue so raised on social welfare activities.

iv. Increasing employment opportunities: Fiscal incentives, in the form of tax-rebates and concessions, can be used to promote the growth of those industries that have high employment generation potential.

v. Price stability: Fiscal tools can be employed to contain inflationary and deflationary tendencies in the economy.

The main objectives of fiscal policy in developed countries are:

i. To raise the level of investments: The main objective of fiscal policy in a developed county should be to raise the volume of production keeping in view the fact that the level of production should not be higher than the level of consumption. Now to increase production, it is essential to raise the level of investment. The level of production should be increased by increasing effective demand.

ii. To check the fluctuations in the effective demand of money: In developed countries there exists irregular unemployment. If the people do not like to work in spite of the available opportunities of work or if they possess so much income that they can lead healthy life even without doing any work, it will lead to irregular unemployment. The manpower will become idle. Now to control irregular unemployment, it is essential to check fluctuations in the effective demand of money.

iii. To control the automatic process of the market: Today, all the economists are of the opinion that on reaching the developed economy at the top, it cannot be left alone. This fact has been verified by 1930 worldwide depression. The worldwide depression has disturbed the economy of world badly. Hence, in order to avoid the uncertainty of the market, effective control is needed.

iv. Proper direction to government investments: In order to have effective coordination between demand and supply, the Government investments are required to play an important role. Hence, proper direction should be given to Government investments.
v. **Determination of suitable taxation policy:** In order to establish short-term and long-term balance in the economy, it is essential that there must exist complete coordination between taxation policy, credit creation policy, lending policy, and resources mobilization policy of the Government. Unless there is a mutual coordination between them, it is not possible to bring about stability in developed economy. Prof. Musgrave pointed out the following objectives of fiscal policy in a developed economy:

i) To secure adjustment in the allocation of resources;

ii) To secure adjustment in the distribution of income and wealth; and

iii) To secure economic stabilization (Kumar, N. & Mittal, R., 2002)³.

2.2 **Role of Fiscal Policy in Economic Development:**

Lord Keynes threw out the traditional doctrine of the neutrality of public finance- held since the time of Adam Smith- and laid the foundations of the “functional finance”. He insisted that Government finance should be adjusted to the changing conditions of the economy, to fight inflationary pressures and deflationary tendencies. By assuming that fiscal policy can influence the level of individual and corporate incomes, many economists have recommended the use of fiscal policy to:

a) Achieve optimum allocation of economic resources;

b) Bring about equal distribution of income and wealth; and

c) Going for rapid economic growth. Under the influence of Keynes, the promotion and maintenance of full employment was regarded as the most important objective of fiscal policy.

The concept of fiscal policy in developing countries suggests a relatively homogeneous body of fiscal instruments applicable to such countries and also, perhaps more important that public finance and fiscal policy in developing economies constitutes an academic discipline distinct from its counterpart in the more advanced economy. Both notions are certainly false, the former being contradicted by the greater diversity in conditions pertaining to third world countries when compared with the more integrated advanced economies, whilst the latter encounters the objection that policy objectives, fiscal instruments and both political and administrative constraints are in principle the same(Shaw, G.K., 1981)⁴.
For developed countries which experienced the process of economic development over two centuries ago under conditions of frugality and dexterity—self-finance by economic units was the primary source of capital accumulation. For the present-day developing world, time is of the essence. Rising aspirations place pressures on limited savings and there is a broader role for credit in investment and in entrepreneurial development. Unlike in developed countries where market forces help to evolve financial institutions and instruments, the developing economies have to make deliberate efforts to promote and nurture diverse institutions and instruments as part of the process of development. With the system of physical controls and regulations gradually losing its hold, the banking industry and financial system in developing countries will have a larger role in establishing investment and production priorities (Malhotra, R.N., 1991).\(^5\)

The importance for economic development of a comprehensive integrated and efficient fiscal policy in general and taxation policy in particular is undoubtedly pivotal. However, in the context of underdeveloped countries the fiscal measures need to be reformed in such a way as to achieve a number of accepted objectives—which are primarily related to the basic goals of rapid economic development and establishment of a desired pattern of distribution.

The role of fiscal policy in the process of economic development occupies a dominant place among all the special tools of the government employed to direct and control the economic affairs of a country. But fiscal theories propounded with reference to developed countries do not, generally, suit to the requirements of underdeveloped economies, mainly due to peculiar economic conditions prevailing in these countries. The classical economists followed the principles of ‘fiscal neutrality, and advocated to slim the size of public sector and to reduce the functions of government to the minimum possible extent in order to have a free play of market mechanism. They advocated a tax structure which disturbed the pricing system as little as possible including the pricing of factors of production (Hansen, A.H., 1941).\(^6\) In modern times, classical ideas are irrelevant in case of advanced as well as under-developed countries as fiscal policy has to play an important role in the fields of economic growth and economic stabilization in these countries.

The theory of national income and employment, originally developed by Keynes, shed new light on the relation of Government finances to the level of income and employment in the economy. It was realized then that Government finances could
be manipulated to influence the level of economic activity, by influencing the level of effective demand. This is the genesis of the modern concept of fiscal policy in advanced economies. Its underlying notion is that the revenue and expenditure programmes of the Government should be so adjusted as to produce and maintain a stable and high level of economic activity (Chelliah, R.J., 1960). The fiscal policies advocated by Keynes and Lerner are, generally, concerned with achieving 'short-term stability' in the economy. Keynes regarded fiscal policy “as a balancing factor” (Keynes, J.M., 1936) which would “bring about an adjustment between the propensity to consume and inducement to invest” (Ibid). He visualized the operation of a fiscal policy in the context of a static model in which skill and quantity of labour, technique, degree of competition and tastes and habits of consumers, etc. were assumed constant and a certain rate of growth was assumed. According to him, “The economy tends to fall below this rate of growth because investments do not equate themselves with the potential savings of the system” (Ibid). Keynes advocated increase in effective demand and reduction in savings and these factors made his theory irrelevant to economic development in under-developed countries. For achieving economic development in under-developed countries, it is necessary to use fiscal policy for restraining propensity to consume and thus raising propensity to save. Keynes advocated a rise in the level of investment in order to increase national income and employment. This rise was restricted to a level which utilizes all the potential savings of the economy. But, in underdeveloped economy if the volume of investment is limited to savings, it would tend to stay stable at a level of underdeveloped equilibrium as savings constitute a comparatively much lower proportion of its national income.

Two important implications of this concept of fiscal policy are worthy to note here. First, the finances of the Government should be conducted on a ‘functional’ basis, and revenues and expenditures should not be considered as being occasioned solely by the requirement of securing collective consumption. This view of public finance may be called ‘functional finance’. Secondly, the budget needs not always be balanced. Under conditions of less than full employment, for instance, a deficit would be desirable (Chelliah, R.J., 1960). It is the concept of functional finance which constitutes the real revolution in point of view. If the Government’s expenditure and tax programmes are to be treated on a functional basis, the simple analogy with private finance no longer holds good. Expenditure may be incurred not mainly for the sake of its direct benefit, but for the sake of the indirect effect it produces in the form of a rise
in employment; and revenue may be raised not to meet a proposed expenditure, but to curtail effective demand. It follows that taxation no longer can be looked upon merely as a means of finding the money for the state; it becomes one of the primary weapons in the hands of the Government to promote stability and progress. Functional finance, thus deliberately aims at unbalancing the budgets with a view to attaining and maintaining full employment level in a developed economy. In an underdeveloped economy, however, the main problem is not one of full employment but that of rapid economic growth. In a developing economy, thus, the functional aspect of fiscal policy is to be conceived in the context of a planned process of economic development. In the words of Tripathi, “The requirements of economic growth demand that fiscal policy has to be used for progressively raising the level of investments and savings and thus the criteria of fiscal policy in developing economy are different from those of functional finance” (Tripathi, R.N., 1964).

In the early Keynesian era, the preoccupation was with the problem of short-run stability and with counteracting cyclical fluctuations. Attention was given mainly to the perfecting of a counter-cyclical policy. Pressing short-run problems—the depression of the thirties and the inflation of the first world war and post-war years—absorbed all attention, to the neglect of the long-run problems of growth. More recently, however, condition for long-run equilibrium in a dynamic economy have been analyzed, and the possibility of the emergence of long-run disequilibrium has been pointed out, calling for a shift in emphasis in the goal of fiscal policy. The goal postulated now is that of insuring conditions of stable growth (Chelliah, R.J., 1960). Mr Harrod (Harrod, R.F., 1948) and Professor Domar (Domar, E.D., 1957) have been in the forefront of the economists who have tried to study the requirements of steady growth in an economy. The growth models developed by Harrod and Domar gave a strategic importance to capital accumulation in the process of economic growth. They emphasized that investment has a dual character: on one hand investment creates income and on the other, it augments the economy’s productive capacity by enlarging its capital stock. According to Harrod’s model, if equilibrium is to be maintained in an expanding economy at the level of full employment, the actual rate of growth must correspond to the warranted rate of growth. The rate of growth required to maintain full employment without inflation is referred to as the required rate of growth (Musgrave, R.A., 1959). Musgrave assigned the similar rate to fiscal dynamics in economic growth of advanced economics. According to him, the problem of fiscal
dynamics in economic growth is “one of securing a growing level of capacity income at stable prices” (Ibid). Harrod-Domar growth models assume an economy at an advanced stage of economic development and with a high rate of capital accumulation. In such an economy, if unemployment develops, this is due to deficiency of effective demand and the situation can be remedied by raising the rate of investment expenditures in money terms. In under-developed countries the problem of ensuring the purchase of growing output at stable prices is not very important because there is always pressure of money demand on the limited productive capacity of the economy. Thus, fiscal policy has to play distinct roles in the process of economic development in case of advanced and under-developed countries. Broadly speaking, “Whereas the maintenance of stability will be assigned the first priority in an advanced economy like the United States, capital accumulation would have to be assigned first priority in an under-developed economy, like India” (Chelliah, R.J., 1969).

Fiscal policy has an important role to play in regard to accumulation of human capital and promotion of education and skills. Human resource development is a vital element in social welfare activities of the state; and transfer payments for purposes of development of education and skills, health and family welfare- as also housing- constitute an important part of government’s social expenditure. The modern concept of human development index (HDI) has attracted considerable attention and may be considered. The total quantum of allocation of budgetary funds for providing education, health facilities and the various factors that contribute to improvement in standards of living of the masses is a prime determinant for improving HDI. Fiscal policy has an important role to play in determining not only the overall volume of funds, but also in channelizing these funds in the manner best calculated to maximize human capital accumulation. An important aspect of budgetary formulation is the decision to allocate available funds between various areas of research: military research, nuclear and space development; scientific research; industrial, medical and other research. It follows that if budgetary allocations in accordance with the government policy give primacy and direct large funds to military research, and funds for industrial or other research are inadequately provided for, it could have an impact upon development of industrial technology and the competitive capacity of industry.

Fiscal policy has an important role to play in the development of infrastructure. The quantum of funds to be allocated every year for development and maintenance of infrastructure are decided by the finance ministry on basis of requisition for funds from
the concerned ministries. However, the total allocation would depend upon the availability of funds in the budget. The bulk of infrastructure in many developing countries is provided by the state. In many cases, there is an element of subsidy, often implicit, in the prices that are charged to consumers. This imposes a burden on the budget and deprives other sectors of the economy of resources. Actually, the government should endeavour to increase user-charges to reduce the gap between cost and charges, so as to reduce budgetary deficit. Budgetary policy has also to determine expenditure allocation among and within infrastructure sectors: between irrigation, power, transport and communication; on new construction or maintenance of existing works; between rural and urban sectors; and between different districts and regions. So, it may be observed that allocative efficiency of resources is increased, provided infrastructure services are efficiently delivered (Kothari, S.S., 2001).

The process of economic development accompanied by a large amount of investment tends to be, inherently inflationary because it tends to generate additional effective demand in the economy without an immediate and corresponding increase in the output of consumption goods. Therefore, the methods adopted by the government for financing its development plans must ensure that mobilization of adequate volume of resources is compatible with the maintenance of a reasonable measure of economic stability. Fiscal policy can play important role in counteracting inflationary tendencies and in influencing the structure of relative prices in the interest of economic development. The progressive tax structure is an effective fiscal stabilizer as it has a built-in-flexibility. Thus, if a tax structure has to work as an effective stabilizer, the marginal rate of taxation should be very high. But a highly progressive direct tax policy may adversely affect savings investment and output. Therefore, “Tax policy must be judiciously planned and it should discriminate in favour of essential production and consumption and against speculative investment and non-functional consumption” (Tripathi, R. N., 1964). In under-developed countries like India, direct taxation covers very small segment of the population, therefore, progressive rates of commodity taxation work as better economic stabilizer. As economic development takes place larger part of income accrues to those persons who own means of production. Income is redistributed in favor of rich persons; hence a redistribution of income in favor of poor persons is required. Any fiscal programme which involves improvement in the quality of manpower like education, training, health, housing, sanitation and subsidies on food and clothes, etc. generally benefits poor classes. To
the extent that tax finances this process of human capital formation at the expense of lavish consumption and speculation, etc., it results in redistribution of income in favour of poor persons. Generally, it is argued that redistribution of income in favour of poor persons may adversely affect savings and investment by entrepreneur class. But high income in underdeveloped countries may, comparatively speaking, be derived from such sources and devoted to such uses that the disincentives effects are less damaging than in developed countries.

Through fiscal policy the Government creates and sustains the public economy consisting of the provision of public services and public investment; at the same time it is an instrument for reallocation of resources according to national priorities, redistribution, promotion of private savings and investments, and the maintenance of stability. Thus, fiscal policy has a multi-dimensional role. It particularly aims at improving the growth performance of the economy and ensuring social justice to the people.

Fiscal policy plays a central role in enabling a country to achieve its economic and social objectives, from macro-economic stability to sustainable growth and poverty reduction. Specifically, in the 1990s, fiscal policy has also assumed importance in the policy deliberations of most countries since concerns with fiscal dimensions, such as high unemployment, inadequate national savings, excessive budget deficits and public debt burdens have intensified. Looming crises in the financing of pension and health care systems are also putting pressure on fiscal policy management (Caron, Y., 2002). In order to accelerate the growth of the economy, fiscal policy is used:

a) to mobilize the human and material resources of the economy and maximize their flow;

b) to promote savings in the economy and minimize current consumption;

c) to direct investment in the desirable channels both in the public and in the private sectors by providing suitable incentives;

d) to restrain inflationary forces in order to ensure economic stability;

e) to ensure equitable distribution of income and wealth in the country so that the fruits of development are fairly distributed. Reduction of economic inequalities and prevention of concentration of economic power become the major objectives of fiscal policy in developing countries; and
f) to protect the economy from unhealthy development abroad, i.e., to reduce the exposure of the economy to the ebbs and flows of world markets and to eliminate or reduce dependence on foreign food or foreign investments.

The role of fiscal policy can be likened to the driving of a car. While driving up a gradient (i.e. stepping up production and productivity), what is needed is an increase in power (promotion of higher saving and investment through fiscal measures). On the other hand, when it moves against the national interest it is necessary to control the supply of power (to combat inflationary and foreign exchange crises through higher taxation) and also to apply brakes judiciously to ensure that the vehicle does not slip out of control but keeps on moving all the same. The national exchequer should see that the brakes are not pressed so much as to bring the vehicle to a stop (Rastogi, K. M., 1965)\(^{22}\). A sound fiscal policy, responsible social spending and a well functioning and competitive financial system are the elements of good governance that are crucial to economic and social development. Strategies for moving forward include, inter alia, disciplined macro-economic policies and fiscal policy, including clear goals for the mobilization of tax and non-tax revenues and responsible public spending on basic education and health, the rural sector and women. The Monterrey Consensus adopted at the International Conference on Financing for Development has recommended, inter alia, that developing countries and economies in transition should set up an effective, efficient, transparent and accountable system for mobilizing public resources and managing their use by Governments as also emphasized the need to secure fiscal sustainability, along with equitable and efficient tax systems and administration, as well as improvements in public spending that do not crowd out productive private investment (Shende, S. N., 2002)\(^{23}\).

**A. Fiscal Policy and Resource Mobilization:**

Economic development has two main props- plan implementation and development financing. Planning and finance are interdependent with each other. One of the essential conditions for successfulness of planning is its financing. A plan, whether big or small in size, can be framed and implemented only when its scheme of financing is so well-devised that sufficient financial resources become readily available as and when required for meeting the development outlays of the process of planning. Availability of finance means mobilization of resources, entirely depends upon the extent of measures taken together for resource mobilization, refer to the
scheme of collecting of funds for financing the plan. Hence, the term ‘resource mobilization’ stands for the collection of funds to allocate resources for meeting the plan outlays which covers not only taxation but the income from public services, public enterprises and public utilities (Gadgil,D.R.,1969)^24. In other words, the task of mobilizing resources involves not only direct measures of taxation or changes in service charges, but also deliberate decisions on selection of major investments, control of expenditures, monitoring of performance and realization of planned levels of economic activity, in a broader view, prevention of tax evasion and tax avoidance and changes in the tax structure are, of course, crucial (Singh,Tarlok.,1947)^25. Mobilization of resources also means creation of ‘economic surplus’. This is possible by mobilizing the existence of difference between the actual current output and actual current consumption in the economy and to continually enlarge it by curbing increments in consumption (Chelliah,R.J., 1969)^26. Mobilization of economic surplus would enable the Government to acquire funds with the help of which it can obtain resources and can direct them into developmental projects. Both direct and indirect taxes are instrumental for tapping such type of surplus.

Mobilization of resources in the monetized world means raising of necessary finance for developmental purposes. Thus, finance is the mobilizer of resources. Mobilization of financial resources and economic development are synonymous with each other. The economic development is the function of mobilization of financial resources plus productivity of capital minus rate of inflation growth caused by excessive use of the technique of deficit financing. Resource mobilization is a direct means to the outcome of sustained growth. A decline in the resources mobilized may result in failure to attain the growth targets. It is for this reason that in a mixed economy inadequate resource mobilization manifests itself in internal and external instability.

The nature and extent of problem of resource mobilization is somewhat different in underdeveloped countries from the developed countries. For instance, in developed countries the income and the ratio of saving to national income is high while in underdeveloped countries, it is low as the “road to economic development is paved with vicious circles” (Higgins,B.,1959)^27. In underdeveloped economies where marginal propensity to consume is high, only a small part of income is saved for meeting the investment demands. Therefore, in order to raise the level of investment and saving in the underdeveloped economies it is imperative that the level of
consumption must be curtailed. However, in such economies the level of consumption is already low due to low per capita income and it would be difficult to reduce it further. Since this task of capital formation cannot be shouldered by the private sector alone, in the developing economies the Government must come forward to hold this responsibility of raising the level of saving and investment. The Government is expected to guide the economy by anticipating impediments to growth and providing necessary remedial action through institutional and other methods. As Jagdish Bhagwati remarks in this connection, “History seems to underline the importance of state action in engineering and assisting the process of take-off in developing economies. The more backward an economy when it proceeds to modernize itself, the larger tends to be the range of necessary action by the state” (Bhargwati, Jagdish, 1966). In fact, no country has made economic progress without positive stimulus from intelligent Government as has been the experience of England and the U.S.A” (Lewis, W.A., 1960).

Resources can be raised both internally and externally which include revenue from taxation, public borrowing, surpluses of public enterprises and deficit financing and foreign aid, grants and loans from various foreign agencies respectively. The design or pattern of financing of a country is determined by these sources taken together having their distinct nature and contributions. Now, we may examine the nature, importance, extent, usefulness and defects of each source in order to mobilize the financial resources.

I. Taxation:

Taxation is an important instrument to achieve the objective of resource mobilization. As an instrument of resource mobilization for the development plan of the public sector, its principal function lies in raising the volume of public savings to be used for capital formation consistent with the growth in the rate of savings in the economy as a whole (Tripathy, R.N., 1964). Emphasizing the importance of taxation, Mrs. Ursula Hicks has rightly remarked, “Tax bankruptcy was an important contributory factor to the fall of the Roman Empire. Unjust and inefficient taxes set the French Revolution aflame. An important part of the explanation of the Germany’s failure in the war of 1914-18 was her antiquated tax structure... inefficient taxes helped to lose Britain the American colonies” (Hicks, U. K., 1961). Tax policy is, thus, a vital instrument in the hands of the public authority.
Taxation is used as the main policy instrument for transferring resources to the public sector. It can also assist in creating an atmosphere within which the private sector operates in conformity with national objectives. It has been argued by multilateral institutions, among others, that the tax system should be used only to raise finances that are sufficient for meeting the minimum necessary level of public expenditure, such as, to preserve territorial integrity, to maintain law and order, to provide various public goods and to regulate undesirable activities. From the efficiency viewpoint, it can be said that taxes provide the best means of financing the bulk of public expenditures. However, taxes impose three types of cost:

a) A direct cost or revenue forgone, as taxes, as taxpayers reduce their disposable income by paying the amount due;

b) An indirect allocative effect, or excess burden, which is the welfare cost associated with the economic distortions induced by taxes as they alter relative prices of goods, services and assets; and

c) An administrative/compliance cost, since tax forms, tax control, payment procedures and tax inspection are costly (Shende, S. N., 2002).

The use of tax policy for the mobilization of development finance for the public sector in a developing country may be considered in two aspects – (i) static and (ii) dynamic. In the static aspect, when the economy tends to stay at a stable level of underdevelopment equilibrium, taxation as an instrument of development finance should impinge on the consumption constitute of the aggregate output in such a way that work incentives are not unduly impaired. To the extent that taxation releases resources from non-functional consumption and unessential investment, its importance lies not so much in the reduction of over-all effective demand, but rather in the reduction of demand for certain resources which are thereby set free and made available to the public sector. But in its dynamic aspect, as the aggregate output tends to grow at a higher rate as a result of the initial efforts at planned development, tax policy must aim at preventing the increment in output from being consumed by deliberately siphoning an increasing proportion of it into the pool of investible resources of the public sector. Apart from the low level of per capita output, a number of factors of a purely technical nature operate in low income countries which make it very difficult for them to accomplish as large a proportionate resources transfer through taxation as high income countries. Their administrative mechanism is generally not very efficient partly due to the dearth of trained technical personnel. As a
result of a general lack of education among the tax payers, there exist difficult tax
compliance conditions, including in many cases considerable taxpayer resistance and
little moral disapproval of tax evasion. Due to the small size of the corporate industrial
and commercial sector, it requires a larger proportionate investment of administrative
resources to extract through taxation a significant proportion of the national income in
low income countries as compared with the high income ones. Therefore, the tax
structure is likely to show signs of strain at much lower rates of tax in the under-
developed countries; and as a result, they may fail to utilize to the full, the existing tax
potentials in their economies. Besides, the existence on a large scale of non-monetized
sector also makes it difficult for them to tap the tax potentials of that sector through the
usual forms of taxation. Thus, the success of a developing country in diverting through
the medium of taxation an increasing proportion of the national income into
development financing depends partly upon the improvement of technical conditions
such as improvement in tax administration, partly upon the spread of education, and
upon the growing consciousness of the benefits flowing from larger development
expenditure which will tend to diminish the psychological resistance of the tax payers
and deployment entails institutional innovation both in respect of the elaboration and
use of fiscal machinery for stimulating saving and for raising the investment of public
revenue and in respect of the organization and operation of a capital market for
channeling savings into productive use in the private sector” (World Economic Survey,

In the early stages of the economic development of U.K and U.S.A., their fiscal
structure as a whole favoured the act of accumulation and capital formation and
discriminated against the act of consumption. The economic development of these
countries has been brought about largely by the efforts of a dynamic private enterprise;
and to enable it to plough back its increasing incomes into investment, the structure of
taxation was made highly regressive and the fiscal structure as a whole tended to
redistribute the national income in favour of the investors and savers. According to the
Colwyn Committee, “taxation (in England) in 1818 hardly touched the saving power of
the wealthy” (Report of the Committee on National Debt & Taxation, 1927), and as a
result, “all their savings were available for investment” (Hansen, A.H., 1941). In
regard to the effect of taxation on the pattern of investment, it may so happen that taxes
which reduce the rewards of successful investment may be a disincentive to risk-taking
and this could have adverse effects on economic growth. The more people are encouraged to put their money into saving accounts or to keep in liquid form, the less entrepreneurship is there. Some of the empirical evidences also show that income and corporation tax have greater impact on the pattern of investment than on total savings and investment. But these adverse effects of taxation can be removed by appropriate public investment programmes and a combination of different type of taxes.

In underdeveloped economies, while making an effort at resource mobilization, the state is obliged to rely heavily on indirect taxation for collecting adequate revenue. The base for direct taxes is generally quite narrow and cannot be considered adequate for fiscal needs. In developed economies, however, no such generalization is possible. In their case while some economies rely more on direct taxes, other collect more revenue from indirect taxes. In U.S.A, for example, indirect taxes are only about 1/13 of direct ones, in Canada this ratio is about ½, in Belgium it is about 2/3, in Australia 3/2, and in Norway 7/2.

Taxes curtail consumption and thereby lead to forced savings and releases resources from consumption goods sector and make it available for the capital goods sector in the hands of the Government. In short, increase in taxation implies transfer of resources from households consumption to public sector investment. But, taxes should not amount to reduce output of consumption sector and create scarcity of wage goods, otherwise, it would mean an inflationary impact. Development rebate in taxation provides incentives to investment in the private sector. Similarly, indirect taxes also reduce consumption and increase saving for capital formation. Again taxation may lead to a change in the pattern of production by influencing allocation of resources in the various industries and regions. During inflation, direct taxes may be raised to seize excessive purchasing power and have economic stabilization.

Taxation is quite better than the other means of resource mobilization, i.e. deficit financing particularly in case of raising resources, promoting private investment, controlling inflation and securing an equitable distribution of burden of development finance on all sections of the community. Again since some dose of deficit financing is desirable, a proper system of taxation is inevitable to control the adverse effects of the former. In this way, as matter of fact, taxation is both a substitute and a complement to deficit financing and for this the Government should be tough to taxation.
II. Public Borrowings:

In modern public finance, developmental resources are also mobilized through public borrowings from internal and external sources, in order to meet increasing public expenditure. Government offers savings certificates, bonds, securities, etc. in order to borrow from the citizens and institutions like banks, insurance companies etc. It is referred to as internal public debt. Government may also raise loans from foreign international institutions like World Bank etc. It is called external debt. Compared to taxation, a public debt has distinctive advantages such as:

i. Taxes are compulsory and pinching. While, public debt being voluntary, contribution to Government loans by the people depends on their will. Hence, no element of any psychological pinch or dissatisfaction is involved in public debt.

ii. Taxes have no direct benefits. Loans confer direct benefits to the creditors like bond-holders.

iii. Taxes may have adverse effect on desire to work, and save. Loans have no such disincentive effects.

iv. Taxes are never refunded. Public loans are repayable. So, people always prefer public loans to taxation.

v. Taxes curb consumption by force which may adversely affect the standard of the people. Public loans also induce voluntary savings which, in turn, create an expansionary effect.

vi. Public borrowings implies reallocation of resources from unproductive to productive uses.

vii. Public borrowings can also serve as an anti-inflationary device, because they enable the Government to curb excessive purchasing power and utilize them for increasing the production.

Public borrowing is considered a better method of collecting public revenue than taxation (on the one hand Government will get sources for development programmes and, on the other, conspicuous consumption will be reduced). But it cannot substitute taxation completely because there are certain limitations to the use of this source of financing development. Firstly, public borrowing depends on the credit worthiness of the Government. Secondly, people do not want to lend to the Government because the rates of interest offered by the Government are lower than
those offered by the borrowers in the private sector. And thirdly, if the prices are rising, people will not be interested in saving and lending because of depreciation in the value of money (Aggarwal, Chawla, Medury, Uma, Mukherjee, Indira, Rao & Sopory, Aparna, 2008)³.

However, for a successful programme of public borrowings, the Government security market should be strong. It requires well developed capital and money markets. Again, there is a problem of debt servicing. As such, the Government cannot resort to endless borrowings. Above all, public debt needs to be appropriately managed and fully redeemed in order to maintain the prestige and image of the Government.

III. Deficit Financing:

Deficit financing as a method of resource mobilization has assumed an important place in public finance in recent time. It refers to means of financing the deliberate excess of expenditure over income through printing of currency notes or through borrowings. The term is also generally used to refer to the financing of a planned deficit whether operated by a government in its domestic affairs or with reference to balance of payments deficit. Keynes organized the idea of deficit financing as a compensatory spending meant to solve the problem of unemployment and depression. Modern economists prescribe deficit financing for development purposes.

The concept of deficit financing in the western countries implies financing of a deliberately created gap between public revenue and expenditure or a budgetary deficit. This gap is filled up by Government borrowings which include all the sources of public borrowings viz., from people, commercial banks and the central bank. In this manner idle savings in the county are made active. This increases employment and output. But deficit financing as used in the Indian context is resorted to when there are budgetary deficits. Government borrowing from public and commercial bank does not come under deficit financing as in the west. In Indian context, borrowings from the central bank of the country, withdrawal of accumulated cash balances and issue of new currency are included within the purview of deficit financing. The technique of deficit financing has its historical origin in war finance. In war times, the Government tends to resort to deficit financing in order to quickly acquire a command over resources to meet the growing war expenses. As a rule, however, deficit financing is unproductive when it is used in the case of war finance. Deficit financing during war is always
inflationary because monetary incomes and demand for consumption goods rise but usually there is shortage of supply of consumption goods. The use of deficit financing during times of depression to boost the economy got impetus during the great depression of the thirties. It was Keynes who established a positive role for deficit financing in industrial economy during period of depression. It was advocated that during depression, Government should resort to construction of public works wherein purchasing power would go into the hands of people and thereby demand would be stimulated. This will help in fuller utilization of already existing but temporarily idle plants and machinery. Deficit spending by the Government during depression helps to start the stagnant wheels of productive machinery and thus promotes prosperity. Deficit financing for development, like depression deficit financing, provides stimulus to economic growth by financing investment, employment and output in the economy. On the other hand “development deficit financing” resembles “war deficit financing” in its effect on the economy. Both are inflationary though the reasons for price rise in both the cases are quite different. When Government resorts to deficit financing for development, large sums are invested in basic heavy industries with long gestation periods and in economic and social overheads. This leads to immediate rise in monetary incomes while production of consumption goods cannot be increased immediately with the result that prices go up. It is also called the inflationary way of financing development. However, it helps rapid capital formation for economic development. Deficit financing in developing country is inflationary while it is not so in an advanced country. In an advanced country the Government resorts to deficit financing for boosting up the economy. There is allround unemployment of resources which can be employed by raising Government investment through deficit financing. The result will be an increase in output, income and employment and there is no danger of inflation. The increase in money supply leading to demand brings about a corresponding increase in the supply of commodities and hence there is no increase in price level. But, when, in a developing economy, the Government resorts to deficit financing for financing economic development the effects of this on the economy are quite different. Public outlays financed by newly-created money immediately create monetary incomes and, due to low standards of living and high marginal propensity to consume in general, the demand for consumption of goods and services increases. But if the public investment is on capital goods, then the increased demand for the consumer goods will not be satisfied and prices will rise. Even if the outlay is on the
production of consumption goods the prices may rise because the monetary income will rise immediately, while the production of consumer goods will take time and in the meanwhile prices will rise. Though investment is being continuously raised (through taxation, borrowing and external assistance), most of it goes to industries with long gestation period and for providing basic infrastructure. Though there is effective demand, resources lie under or unemployed. Lack of capital, technical skill, entrepreneurial skills etc. are responsible in many cases for unemployment or underemployment of resources in a developing economy. Under such conditions, when deficit financing is resorted to, it is sure to lead to inflationary conditions. Besides, in developing economy, during the process of economic development, the velocity of circulation of money increases through the operation of the multiplier effect. This factor is also inflationary in character because, on balance, effective demand increases more than the initial increases in money supply. Deficit financing gives rise to credit creation by commercial banks because their liquidity is increased by the creation of new money. This shows that in developing economy total money supply tends to increase much more than the amount of deficit financing, which also aggravates inflationary conditions. The use of deficit financing being expansionary becomes inflationary also on the basis of quantity theory of money. Deficit financing has proved to be conducive to economic development, especially in countries with acute shortage of capital. Deficit financing in developing economies can be regarded as a necessary evil which can be tolerated only to the extent it promotes capital formation and economic development. This extent of tolerance is known as safe limit of deficit financing. To minimize the inflationary effects of deficit financing during the process of development, certain measures have to be taken like proper channelizing of investment in areas with low capital-output ratio, adoption of policies of physical control like rationing, import of only necessary capital equipment etc. In economies with low capital formation, deficit financing becomes a necessary and positive instrument if used with efficient and well executed plan of economic development (Aggarwal, Chawla, Medury, Uma, Mukherjee, Indira, Rao & Sopory, Aparna, 2008). Deficit financing can give a boost to development process. It makes optimum use of unutilized resources possible through effective mobilization in the country’s economy. Again, deficit financing may cause a price rise and reduction in consumption. Thus, it implies a forced saving. Since poor countries lack voluntary savings, forced savings through deficit financing is much desirable phenomenon.
When this forced savings leads to capital formation, productivity and output increase, and bring down the price level. Thus, inflation is in due course self-destructive. As IMF Staff Paper states, “the expansion of money supply within proper limits in a growing economy represents an increment of real resources for investment so long as the expansion of money supply (caused by deficit financing) is no more than enough to finance the larger volume of production, consumption, and investment at stable prices; it is not only non-inflationary, but is essential to the proper functioning of the economy.

With a view to mobilization of resources of the country these various instruments can be used as a complementary method to each other and the duty of an intelligent Government is to evolve a mutual and judicious combination of them for the required purpose. But, under certain circumstances, the policy of taxation is the most effective fiscal instrument for raising resources for the development of the public sector, accelerating development of private sector, controlling inflationary pressures and improving the even distribution of income and wealth. Taxation does not create any greater real burden on the community than would be caused by an equivalent amount of public borrowing owing to the fact that they do not raise the intense problem of repayment of interest on capital in the future. Successive increment in public debt may accentuate inequality, dampen incentives to the entrepreneurs and create a big pressure of inflation on the smooth growth of the economy. The experience of post-war development in different countries show that the inflationary potential of a big development programme can be held within bounds by an appropriate degree of surplus budgeting on revenue account. In this way, taxation becomes indispensable both as a complement and a substitute to borrowing despite knowing the fact that taxation is unjust and harbinger of hardship to the people. A developing country can, therefore, escape from increased taxation only at its own peril (Mishra, B., 1978)39. Likewise, when we compare taxation and deficit financing, we find no compromise with deficit financing which is considered to be the most important cause of economic peril in the under-developed countries by sustaining pain of inflationary jerks. Deficit financing is a quicker technique to raise resources. Therefore, it can be asserted that “under the constraints of tax administration, taxes should be selected in a way that reflects the realities of the environment in which they are enforced, they must provoke the least resistance possible from taxpayers and establish through their multiplicity the necessary tax illusion which enables
Government to increase its share in gross national product and effectively contribute to economic development.

**B. Fiscal Policy and Allocative Efficiency:**

Economics deals with the efficient use of resources in best satisfying consumer wants. If the economy consisted of one consumer only, the meaning of efficiency would be quite simple. Robinson Crusoe would survey the resources available to him and the technologies at his disposal in transforming these resources into goods. Given his preferences among goods, he would then proceed to produce in such a way and such a mix of output as would maximize his satisfaction. In doing so, he would act efficiently. But the real world problem is more difficult. The economic process must serve not one but many consumers; and various outcomes will differ in their distributional implications. This calls for a more careful definition of what is meant by “efficient” resource use (Musgrave, R. A, & Musgrave, P.B., 1973).

The Governmental operations basically involve the efficient provision of Government funds in maximizing the welfare of the community. The Government taxes the public and uses the amount in providing certain facilities and services considered essential by the people and the community. These facilities are such that they could not be provided by the people themselves (e.g., defence) or they could be provided but only at a high cost (e.g., education and medical facilities). Fiscal operations of taxation and public expenditure have the effect of transferring resources from the public which would have been used for consuming private goods to produce social goods which would satisfy collective wants. The objective of fiscal operations is to provide for the proper allocation of resources between private and social goods so as to maximize social welfare. The primary task of fiscal policy in under-developed countries is to raise the ratio of savings to national income. The need is much more urgent than is generally recognized by policy makers in these countries. And there is reason to believe that well-devised policy measures can succeed in making available a larger flow of resources for economic development. This means that the role of fiscal policy in underdeveloped countries essentially has to be allocative. It is concerned with allocating more resources for investment and restraining consumption. By contrast, fiscal policy in developed economies is concerned mainly with regulating the total flow of purchasing power, with determining the level of total effective demand. Speaking of the United States, Arthur Smithies says: ‘fiscal policy aims primarily at
controlling aggregate demand and leaves to private enterprise its traditional field - the allocation of resources among alternative uses'. It is obvious that in an underdeveloped country the emphasis has to be on allocation, that is, the broad allocation as between consumption and investment, and as between forms of investment. True, in a developed economy too, under certain circumstances, the rate of investment might have to be changed by public policy. But in the conditions prevailing in the developed economies at the present stage of their development maintenance of stability - short-run and long-run - remains the keynote of fiscal policy, whereas in the underdeveloped countries the keynote of policy must be acceleration of the rate of growth (Chelliah, R. J., 1960).

Fiscal policy also influences growth performance of an economy through its effects on the allocation of resources. An efficient and rational allocation of resources will obviously be helpful in raising the rate of economic growth. Therefore, if fiscal policy favorably affects the efficiency of resource allocation, then in the process, growth performance of the economy is bound to improve. An indifferent fiscal policy adversely affecting the efficiency of resource allocation on the contrary retards the productive activity and thereby results in lower rate of economic growth.

Among the various instruments of fiscal policy perhaps tax policy is the most important determinant of the efficiency of resource use. It has been observed that the allocative effects of direct taxes are superior to those of indirect taxes. If a particular amount is raised through a direct tax like income tax, it would imply a lesser burden than the same amount raised through an indirect tax like excise duty. This is because an indirect tax involves an excessive burden since it distorts the scale of preference due to price changes caused by its imposition. Thus, in practice, the allocative effects of indirect taxes would be superior to those of direct taxes provided the Government chooses the indirect taxes judiciously. In an underdeveloped economy, there is a need to shift the resources toward various priority industries and indirect taxes can be of help there. Even in a modern developed economy, there are usually numerous imperfections, monopolies and so on, as also a good deal of divergence between social and private costs on the one hand and between social and private benefits on the other. However, production of certain high priority goods may be lower not because resources invested in them are too few, but because due to market imperfections there are unutilized capacities as in the case of monopolies and monopolistic competition. The appropriate approach in breaking a monopoly is not to push more resources into it

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through taxation of goods produced by competitive industries and subsidizing the goods produced by competitive industries and subsidizing the goods produced by monopolies. Instead, steps should be taken whereby monopolies are forced to make use of their unutilized capacities.

Another reason on account of which a judicious use of indirect taxes turns out to be better than direct taxes in their allocative effects is the fact that it is rather difficult to have really proportional income taxation. The very concept of taxable income is an imprecise one and its definition differs from country to country and even within the same country from time to time. So, it is not easy to lay down exact standards by which to estimate the expenses for earning the income, or by which to estimate the depreciation. In a modern economy, due to changes in prices and other uncertainties, there are capital gains, windfall profits and casual incomes, which pose difficult problems of devising a system of proportional income taxation. In practice, the above comparison between the allocative effects of a proportional income tax with those of an equal-yield indirect tax is an academic exercise only, since a modern Government is expected to prefer a progressive direct income tax with an exemption limit to a proportional income tax.

Direct tax will have a resource allocative effect by changing the relative attractiveness of different sources of income. On this basis, therefore, supplier of labour would shift from one employment or industry to another if by so doing he can reduce his direct tax liability more than the reduction, if any, in his earning from the supply of his labour. If he finds that by shifting his employment, his tax liability remains unaltered, there would be no reallocative effect on existing labour supply in the economy. If in general taxation reduces one's earnings from each type of investment substantially, then there will be a tendency for savings to go uninvested or get invested into those lines from which little or no income may be expected. Taxation of earnings from investment would tend to reduce the supply of savings and investment in general. But a system of differential taxation causes a resource reallocation effect also. A direct tax can also have an indirect effect on resource allocation. Through a shift in income distribution or even otherwise, a direct tax can lead to a shift in demand pattern and cause a reallocation of productive resources.

In addition, diversionary effects of taxes are, however, beneficial and socially very much desirable. In a free economy, very often, undisturbed economic forces may tend to establish a pattern of production which may not be desirable from the social
welfare point of view. In such cases, certain forms of taxation may achieve a desirable reallocation of resources, causing improvement in the social benefits. For instance, in a developing economy when luxuries are taxed at a progressive rate, resources will be diverted from such non-essential goods industries to the essential goods industries. Similarly, if harmful goods like tobacco, opium, liquor, etc., are highly taxed so that their consumption is curbed, production of such goods will be reduced and the realized surplus resources would then be made available for better purposes like capital formation, etc. when such allocative effect takes place it is beneficial to the society, which is welfare-oriented, as it implies efficient and optimum use of the scarce resources. Similarly, concessional taxation on priority industries and heavy taxation on non-priority industries tend to divert the flow of resources (land, labour, capital, etc.) from the latter to the former, which would be a socially desirable channelisation of resources. Likewise, when a protective tariff is raised, it will cause a diversion of the productive resources from non-protected industries to protected industries which might have been assigned a strategic position in the country’s economic development. Moreover, a significant diversionary effect of taxation is to shift resources from the present use to future use or sometimes from future use to present use.

Apart from a change in the use of resources, taxes may lead to a shift in resources from one region or place to another. In fact, the main object of a modern public policy is to promote a balanced regional growth, which calls for re-allocation of resources from advanced regions to economically backward regions. This can be effected through appropriate adjustments in the tax structure and tax rates in the different regions. Since the resources have a natural tendency to move from a high-taxed region to a low taxed region, it follows that the Government has to tax the developed regions more heavily than the backward regions, in order to bring about a desired transfer in the interest of balanced growth. Otherwise, if the differential rates are adopted at random by the states in a federation, a lopsided development may result. Thus, the overall effect of the tax policy on allocation of resources should not be judged in isolation because a well-devised system of public expenditure may more than compensate any adverse effect of taxation of production. The basic thing, however, is that the revenue obtained through taxation must be wisely spent, which would help in increasing economic and social welfare in the community.

Public expenditure can help the economy in numerous ways in attaining higher levels of production and growth. The ways in which such effects might be brought
about are obviously inter-related. The analysis of these effects can be taken up separately in the context of developed and underdeveloped economies. Developed market economy has enough of flexibility but may be suffering from a deficiency of effective demand. Public expenditure can add to the effective demand directly and thus, generate conditions favorable for the market forces to push up production. Such public investment need not be productive in the sense of adding to the supply side of the market also. This public investment can just be a means of disturbing purchasing power to those who would spend the same and add to the effective demand. But the technique of increasing production through increasing demand becomes ineffective once the level of full employment is reached. Money income goes up but real income does not increase correspondingly because real income depends upon the use of real resources. If, therefore, demand is pushed beyond full employment, it will only add to inflationary pressures. Further, public expenditure may not be able to push up production proportionately because of various rigidities from which even a developed economy is likely to suffer. For example, some industries may not have unutilized excess capacity when demand goes up. In some industries monopolistic practices may be in vogue and there can be strong militant trade unions. Under different technical and other types of rigidities the economy may not be able to respond fully to increased demand. The result is likely to be a partial increase in production when demand increases through the use of public expenditure and the results can be quite inflationary beyond a limit. Once rigidities are recognized from which a developed economy may be suffering and the corresponding lack of complete inter-flow of demand between its various sectors, the co-existence of inflation and unemployment cannot be ruled out. In such a case, the authorities cannot be indifferent as regards the manner in which public expenditure generates additional demand in the economy.

The case is a different one with underdeveloped economies. Such economies are characterized by a low level of saving and investment activity. This deficiency, again, may be remedied by stimulating private saving and investment, or through direct public saving and investment, or both. Thus, in underdeveloped countries, there is a shortage of social overheads, skilled labour, capital equipment and machinery. Public expenditure can be directly used to create and maintain social overheads. It can also be used to create human skills through education and training. In India, good deal of regional disparities is found. Certain districts, or parts thereof, have been enlisted as economically backward. Various tax concessions and credit facilities are being
provided for setting up industries in these areas. Public expenditure can be used to provide necessary economic infrastructure for the development of selected economic activities and can be used to give subsidies for increasing their profitability. Thus, the authorities can add to the process of capital accumulation. To the extent this capital formation is financed through foreign aid, the process of economic growth is accelerated.

Public expenditure may also be used to encourage the market sector of an underdeveloped economy for contributing to the process of economic growth. It is not necessary that all the additional investment should be in the form of direct public investment only. Public expenditure can help private investment and production through measures which reduce the cost of production, or push up demand or remove particular shortages and bottle-necks. Creation and maintenance of social overheads lead to an all-round reduction in cost of production and improvement in efficiency. This, therefore, increases profitability and production. Also social overheads bring different regions and sectors of an economy in closer contact, and thereby stimulate the process of economic growth. Also, public investment can go directly into the development of basic and key industries, power, irrigation and mines etc. through these steps, the economy can add to its infrastructure and thus provide a firm basis for growth.

Public expenditure can bring about a better allocation of economic resources as between the present and the future. In a free capitalist society very little provision is made for the future. This is because people prefer the present rather than the future and, therefore, they do not make adequate provision for the future. The state, on the other hand, is the custodian of the interests of the future generations also and, therefore, has to see that adequate provision is made for the future. Thus, certain type of public expenditure such as those on multi-purpose projects, road development, urbanization schemes, etc. do not yield immediate returns but confer social and economic benefits on the future generation. Public expenditure also results in diversion of resources between different regions and thereby reduces regional inequalities.
C. Fiscal Policy and Equity:

The conception of fiscal equity, that is, equal treatment for equally situated individuals, has been applied to the distribution of taxes, but not to the distribution of expenditure in the same manner. This equity criterion, although motivated on grounds completely divorced from economic efficiency, does carry with it certain implications for efficiency in the structure of private choices. The equal-treatment-for-equals principle does not guarantee that private choices are not modified by the fiscal structure, but it does, if fully applied, serve to prevent differential effects on separate groups or individuals. The meaningfulness of this equity principle depends, however, on the way in which “equals” are defined for purposes of fiscal treatment. Differential taxes could be imposed without violation of the technical version of the equity principle if the group of “equal” is defined sufficiently narrowly. A tax must be applied to rather broad grouping; in other words, “equals” for fiscal purposes must be defined in some reasonable and not wholly arbitrary manner. The general respect for the equity principle in the organization of the fiscal structure has been one factor tending to maintain general neutrality in effects. The deliberate distortion of private choices in a differential way has been prevented, especially in the distribution of taxes. Much of the opposition to the erosion of the income tax base through numerous loopholes, tax shelter, and tax credit schemes stems from the fear that these violate the long-standing principle of horizontal equity. These devices tend to classify individuals, not in accordance with their ability to pay, but in accordance with the relationship of their private activity to some concept of “private interest”. At this point it is suggested merely as one factor which unintentionally, serves to prevent undue distortion of resource allocation mechanism of the private economy by the fiscal structure (Bauchanan, J.M. & Flowers, R.F., 1975)⁴².

It is important to distinguish between the static and dynamic effects of fiscal policy on equity. From the vantage point of comparative statistics the key issues are who bears the tax burden of fiscal policy and who benefits from public expenditure. Of course, even answering these relatively “simple” questions raises knotty theoretical problems. These problems are multiplied when one approaches the issue in a dynamic framework and asks: what has been the effect on, say, the size of distribution of income, over a specified period of time, which can be attributed to fiscal policy? After all, fiscal policy affects growth. And, depending on the structural characteristics of the
economy as well as the policy frame, that growth can be associated with more or less equity in the distribution of income or consumption or wealth (Acharya, S., 1988)\(^4\).

The economic structure of underdeveloped countries is characterized by the existence of considerable inequalities in the distribution of income and wealth. A number of studies made in recent years have revealed that these inequalities are much greater in developing countries as compared to those in the advanced capitalist countries of U.S.A and U.K. The existence of inequality in the distribution of income is held to be conducive to a high rate of capital accumulation; but in the case of the developing countries much of the inequality is of non-functional character which is not justifiable either from the economic or social stand-point. Besides, concentrations of economic power are not compatible with a process of acceleration development in democratic countries because they lead to social and political discontent which undermines the fabric of the body politic and prevents popular participation in the process of development (Tripathy, R.N., 1970)\(^5\). A welfare state should provide social justice by giving equitable distribution of income and wealth. Fiscal policy can serve as an effective means of achieving this much desired goal of socialism in developed as well as developing countries.

Market mechanism by itself generates ever-widening income inequalities. However, the objective of reducing inequalities is likely to come in conflict with that of increasing production and economic growth. The problem is break-up into two parts, short-term and long-term. In short-run, any income and wealth distribution pattern can go in harmony with the production level. Thus, it may be assumed that the total national product is already there and that now the problem is to determine the individual shares of the members of the society. Definitionaly, therefore, this stand makes distribution independent of its effects on production. Such a redistribution of income, therefore, may be brought as close to equality as various tax measures. However, there are following points in this connection.

Firstly, unless there is a total political and economic revolution in a country, a quick redistribution of income and wealth is not a possibility. The process is a time-consuming one if measures like progressive income-tax, wealth tax, gift tax, expenditure tax and the like are to be used. So long as the institutions of private property and inheritance are there, the process towards equality is bound to be a slow one. This implies, therefore, that in reality, a proper degree of redistribution might be expected only in the long-run, and for that reason, it is likely to have its consequences.
on production also. Secondly, even if it were possible to reduce the inequalities to a
desired extent in the short-run, long-term consequences of this policy cannot be
ignored. Thirdly, in an underdeveloped country like India, use of taxation for reduction
in inequalities of income and wealth has its own limitations. Direct taxation, with all
its progressive rates, covers only a fraction of the population. The incidence of tax
evasion further aggravates its ineffectiveness. Indirect taxes, on the other hand, cannot
be progressive enough in spite of their selective coverage and differential rates.
Moreover, indirect taxation is inflationary in character, and adds to inequalities.
Possibility of evading excise and sales taxes further strengthens this process.

In the long-run, a reduction in inequalities brought about by taxation might be
counterbalanced or more than counterbalanced by increasing inequalities of the pre-
taxed incomes. This problem may be solved by very steep taxation so as to practically
mop-off the income above a certain height and effective checking of tax evasion. Steps
towards reducing inequalities can have alternative effects on production and growth. If
the progression of taxes is relatively mild, adequate incentives will be left for everyone
to work hard and contribute towards economic growth. Thus, one acceptable objective
before the authorities can be to check and reduce relative inequalities over time. This
may be done through various progressive tax measures (and, of course, public
expenditure devices also) covering income, wealth, gifts, inheritance, windfalls, capital
gains, etc. coupled with adequate incentives of producers in the private sector and
public sector profitability and savings on the other. However, taxing gifts, unearned
increments and capital gains at even steep rates will not reduce the incentives to work
and earn because these taxes touch upon those receipts which are not based upon
economic efforts of individuals. Wealth tax and inheritance tax, however, can become
a disincentive to save if their rates are too steep.

Thus, if income and wealth inequalities are sought to be reduced through tax
measures, there is bound to be a conflict between this objective and that of growth.
Either, therefore, the state has to abolish the institutions of private property and
inheritance and take over the task of economic growth, or it has to provide enough
incentives in the economy. In an underdeveloped country, such a conflict between
egalitarian and growth objectives is all the more sharp because there is an immediate
need for both. There is abject poverty in the masses which should be reduced to some
extent at least. But final solution of it can come only through economic growth,
otherwise an equality without adequate production would only amount to distributing
poverty. In a developed country, on the other hand, since even the poor are not so poor in absolute term, the objective of equality can possibly be postponed. At the same time, those countries are not faced with an immediate problem of economic growth and so they can afford to go ahead with distribution.

Welfare considerations also favor an equitable distribution of income and wealth. The purpose of an economic policy should be to contribute towards achieving the maximum social benefits. Lerner (1946) has shown that even if we do not know the exact way in which marginal utility of income falls with a rise in income and even if we cannot have inter-personal comparisons of utility, still a shift towards equality would probably add to the aggregate satisfaction of the community. Such a shift towards equality, of course, may be achieved through various forms of public expenditure especially those which are meant to help the poorer sections of the society. A number of welfare measures like free education, health, water and other facilities can be given a top priority. Numerous social security schemes can be adopted whereby people are entitled to old-age pensions, unemployment relief, sickness allowance and so on. Articles of common consumption like food can be subsidized, and the production of those which are in short supply can be taken up in the public sector. Left to market mechanism, the supply of ‘merit goods’ is likely to be insufficient. Public expenditure, through direct purchases, public production or subsidies can ensure that their supply is augmented to the desired extent. Similarly public expenditure, through appropriate subsidies and other ‘purchase and stores’ policy encourage labour-intensive techniques of production which reduce unemployment and improve income distribution.

**D. Fiscal Policy and Economic Stability:**

One of the most important objectives of fiscal policy is to control business depressions and business booms and maintain business stability. The problem of stability refers to that of recurring cyclical phases of upward and downward cumulative movement in income, employment, output and prices, etc. in the economy. In an underdeveloped country, such instability is mainly caused through pressures originating from abroad and imported through shifts in imports, exports, and external resource flows. Recognition of a close relationship between price changes and the level of output and employment, particularly in developed market economies, has led some
economists to claim that economic stability should be interpreted to mean a steady non-inflationary economic expansion in output and employment coupled with a very mild rise in prices. It is normally found that a very mild inflation enables an economy to achieve a continuous expansion.

In a development context, fiscal policy serves both as an instrument of macroeconomic stabilization and as an instrument to achieve growth and poverty reduction objectives. Correspondingly, growth and poverty reduction objectives were under-emphasized. Although stability is necessary for growth, it is not sufficient. The design of fiscal policy needs to identify and also incorporate the transmission channels through which fiscal policy influences long-term growth. This requires that attention be focused on the likely growth effects of the level, composition and efficiency of public spending and taxation. Fiscal policy that neglects these effects runs the risk of achieving stability while potentially undermining long-term growth and poverty reduction. The evidence from countries that stabilized their economies by reducing their deficits indicates that countries often did so by cutting public capital formation significantly, despite its potential negative impact on growth and poverty reduction. While in many cases the decision to cut investments reflected a political preference, the absence of domestic fiscal institutions that would have enabled governments to take a medium term perspective may have contributed to such short-sighted decisions. Fiscal policy has been broadly successful in achieving economic stabilization in part through reductions in fiscal deficits. The fiscal deficit is a useful indicator for purposes of stabilization and for controlling the growth of government liabilities, but it offers little indication of longer term effects on government assets or on economic growth. Conceptually, the long-term impact is better captured by examining the impact of fiscal policy on government net worth. While there are practical challenges to accurately estimating a government’s net worth, there is clearly a need for fiscal policy to incorporate, as best as possible, the likely impact of the level and composition of expenditure and taxation on long-term growth while also maintaining a focus on indicators essential for stabilization (Development Committee, DC., 2006).

The stabilization policy seeks to reduce fluctuations in incomes, output, employment and price level and demand management is one of its principal tools. The maintenance of internal stability, which implies price-stability and high level of employment, postulates an adequate level of aggregate demand, which depends upon the level of expenditure and receipt. Aggregate demand should be adequate to provide
the purchasing power for the goods produced by a fully employed economy and should expand with economic growth. If there is excess of aggregate demand there would be inflation; and if there is deficiency in demand, output would be less than the potential with inadequate utilization of capacity. If there is depression or slackness in the economy, the expenditure should be in excess of revenue so that unutilized resources are used and economy expands. Deficit budgeting may be necessary to increase aggregate demand. The development of the concepts of “multiplier” and “accelerator” and the relationship between the macro-variables like investment, income, consumption, and savings enabled the economists to visualize the mechanics of trade cycles and the role which the fiscal policy could play in an economy. This gave rise to the principals of compensatory finance and functional finance. The modern principle of ‘compensatory finance’- essentially applicable to developed economies- is now accepted as being also applicable to developing economies. Actually, certain amounts of deficit financing and moderate inflation are regarded as means of accelerating growth in developing economies.

It was realized that, to a large extent, fiscal policy can be effectively used by the Government to neutralize the destabilizing forces because depression is caused by a deficiency of effective demand and fiscal policy can remedy it. Similarly, during a boom period the need is to control the demand which can be partly done through curtailing public expenditure and partly through curbing the private expenditure. Thus, Keynesian remedial scheme is essentially neutralizing changes in total effective demand by increasing it during a depression and decreasing it during a boom. During a depression, public expenditure should be increased through incurring public investment and enhancing consumption expenditure of the Government. Similarly, subsidies (with or without tax concessions) can be used to encourage private consumption and investment.

Deficit financing is a very potent tool in the hands of the Government for increasing effective demand. This is more so if the deficit is financed through creation of additional currency or borrowings from the central bank of the country. Even when the Government borrows from the market and spends the borrowed sums, the aggregate expenditure is most likely to increase because during depression the investment opportunities in the market are not much and savings of the market get spent through the Government. However, the Government’s expenditure policy is more effective when the extra purchasing power goes into the hands of those people
who have a high marginal propensity to consume. Various social security measures like unemployment relief, old-age pensions, and so on are, therefore, very helpful in raising the total demand in the market. Productive activity picks up faster and the existing unutilized capacity is put to use if the Government expenditure is directed primarily towards consumption and welfare type disbursements without creating additional productive capacity. In that case, the economy would be able to recover from the depression through the multiplier process.

Taxation is considered an effective tool in encouraging expenditure in the private sector. Ordinarily, a general reduction in tax rates or abolition of various taxes is recommended. This pushes up profits and reduces cost of production and prices. Lower prices are expected to increase demand, production and employment, which in turn add to effective demand, and so on. A similar action can be taken in the field of customs duties also. Raising import duties diverts the domestic demand from imports to home-produced goods; and reducing or abolishing export duties or giving export subsidies increases the demand for exports and contributes towards recovery from depression. Thus, it would be more helpful to lower tax rates on those goods which have a higher elastic demand. Similarly, demand would receive a greater stimulus if persons with a higher marginal propensity to consume are given a relief in direct taxation. In the same manner, investment may be encouraged by specific tax concessions like tax holidays, greater depreciation allowance etc.

When due to large increases in consumption demand by the households or investment expenditure by the entrepreneurs, or bigger budget deficit caused by too large an increase in Government expenditure, aggregate demand increases beyond what the economy can potentially produce by fully employing its given resources, it gives rise to the situation of excess demand which results in inflationary pressures in the economy. This inflationary situation can also arise if too large an increase in money supply in the economy occurs. In these circumstances inflationary-gap occurs which tend to bring about rise in prices. If successful steps to check the emergence of excess demand are not taken, the economy will experience a period of inflation. For the last some decades, problem of demand-pull inflation has been faced by both the developed and developing countries of the world. An alternative way of looking at inflation is to view it from the angle of business cycles. Under such circumstances anticyclical fiscal policy calls for reduction in aggregate demand. Thus, fiscal policy measures to control inflation are reducing Government expenditure and increasing
taxes. If in the beginning, the Government is having balanced budget, then increasing taxes while keeping Government expenditure constant will yield budget surplus. The creation of budget surplus will cause downward shift in the aggregate demand curve and will therefore help in easing pressure on prices. If there is a balanced budget to begin with and the Government reduces its expenditure, say on defence, subsidies, transfer payments, while keeping taxes constant, this will create budget surplus and result in removing excess demand in the economy.

Taxes do act to some extent as built in stabilizer. Given the level of Government expenditure, the tax system itself tends to create a budgetary surplus during a boom and a deficit during a depression. (A budgetary surplus would curb expenditure and demand while a budgetary deficit would have the opposite effect and thus an anti-cyclical pressure is generated. This happens because revenue from indirect and direct taxes is dependent upon the level of economic activities. Moreover, direct taxes are usually progressive. With increasing money incomes, the direct taxes bill rises more than proportionately, and during a depression, there is a more than proportionate reduction in it. Therefore, yield from these taxes also moves in line with the level of economic activities. The result is that during a depression, tax revenue falls, and with given Government expenditure, there is a budgetary deficit, which in turn has an expansionary effect. On the other hand, during boom, larger revenue causes a budgetary surplus which has a contractionary effect. However, it is not enough to rely upon only built-in-stabilizing effect of the tax system. Economic stability requires an all-frontal effort in which variation in tax revenue is only a part. During a boom, the market may develop expectations that prices would rise still further. If that happens, tax measures are not likely to succeed in curbing speculative demand and prices. Similarly, unless producers expect that their investments would be commercially profitable, they would not invest during a depression even when tax rates are lowered. Market imperfections are on the increase even in developed market economies which has adversely affected their adjustability and responsiveness to tax measures. Such limitations of tax devices become more glaring in underdeveloped countries. These economies are riddled with extra rigidities and they have a limited scope for the use of direct taxes. Accordingly, in these countries, the authorities have to rely to a larger extent on non-taxation measures like import quotas and price controls. Even within the tax system, reliance has to be had on indirect taxes on a selective basis. It is found that the fiscal policy has far more chances of success during a depression, but much less in
an inflationary situation. In either case, it will be better if the fiscal policy is helped with appropriate monetary and other measures.

2.3 Nature of India’s Fiscal Policy:

The objective of economic policy in India during the 1950s and 1960s was mainly to increase the growth rate of the economy through increasing public investment and overall economic planning. Taxation was used as an instrument for reducing private consumption and investment and for transferring resources to the Government to enable it to undertake large-scale public investment in an effort to spur economic growth. Furthermore, taxation policy was geared towards achieving the economic objectives of promoting employment through grant of tax incentives to new investment; reducing inequality through progressive taxes on income and wealth; reducing pressure on balance of payments through increase of import duties; and stabilizing prices through tax rebate in excise duties on consumption goods.

Fiscal policy during the 1970s consciously focused on achieving greater equity and social justice and both taxation and expenditure policies were employed towards this end. Accordingly, income tax rates were raised to very high levels, with the maximum marginal rate of income tax moving up to 97 percent and, together with the incidence of wealth tax, it even crossed 100 percent. Over the years, in addition to the commitment towards a large volume of developmental expenditure, the Government’s expenditure widened to include rising subsidies. Large interest payments on growing debt and downward rigidity in prices further contributed to increased current expenditure. Current revenues, on the other hand, were less buoyant leading to the emergence of sizeable revenue deficit in the Central Government budget from 1979-80 onwards, complicating the task of monetary policy.

During the 1980s, Indian public finances were in a state of disarray with the fiscal pattern destabilizing the relationship between the economy and the budget. This resulted in persistently large deficits which were seemingly intractable. Considerable fiscal deterioration took place during the 1980s and eventually became unsustainable, though the growth rate did rise significantly with enhancement in public investment in infrastructure. During this phase, expenditure of the Government was seen as an instrument having a bearing upon aggregate demand, resource allocation and income distribution. The Government sought to reduce its deficit through tax increases.
Custom duties were hiked to augment revenue and to protect domestic industry. There was a structural change in the Government budgets during the 1980s. The emergence of revenue deficit in 1979-80 in the Centre's budget continued to enlarge during the 1980s, raising concerns over the rising public debt and interest payments and the consequent constraint on the availability of resources for meeting developmental needs. The 1980s witnessed a steady increase in market borrowings along with an increase in Reserve Bank’s support to such borrowing, thus compromising monetary policy.

During 1990s, the structural adjustment programme and the consequent economic reforms gave a fresh dimension to fiscal system which focused not only on the various instruments of fiscal policy and issues of debt but also on the overall fiscal sustainability in the context of an open economic framework. Although the first half of the 1990s witnessed some fiscal correction, its retraction during the second half of the decade underlined the need for a consistent and sustainable fiscal consolidation process. The Government, therefore, formulated and enactment the fiscal responsibility legislation which signaled a new dawn in fiscal consolidation.

The performance of the Indian economy in recent years has attracted increasing international interest. An interesting feature of the record of economic growth in India is that it has experienced a sustained slow acceleration in growth since independence. Growth has been accelerating gradually since the 1950s, except for an interregnum between 1965 and 1980. Thus, the current observed acceleration in growth has to be seen in the context of this long record of consistent growth, which has been accompanied by a relatively continuous increase in savings and investment rates over the years. What is remarkable in recent years is the very substantial steep increase in the rates of savings and investment.

It is widely believed that Indian economy witnessed near stagnation in real GDP growth till the late 1970s. A closer review of the performance of the Indian economy, however, suggests a continuing increase in real GDP growth over each decade since independence, interspersed with an interregnum during the 1970s (Table-1). Interestingly, growth of manufacturing production, in terms of decadal averages, was roughly constant at around 5.6-5.9 percent in the first five decades after independence, except for the 1970s. There are two other features of India’s growth history that are notable. First, agricultural growth has been subject to large variation over the decades. The 1970s interregnum is particularly marked by the severe
deceleration in agricultural growth, followed by a marked recovery in the 1980s, and a slowdown thereafter. Second, until the 1990s, little note had been taken of growth in the services sector. A glance at the acceleration in growth in services over the decades, that had earlier been ignored, that really accounts for the continuous acceleration in overall GDP growth, once again, except for the 1970s interregnum.

The slowdown of growth witnessed during the 1970s was reversed during the 1980s; the pick up benefited from the initiation of some reform measures aimed at increasing domestic competitiveness. Since the early 1990s, growth impulses appeared to have gathered further momentum in the aftermath of comprehensive reforms encompassing the various sectors of the economy. There was some loss of the growth momentum in the latter half of the 1990s, which coincide with the onset of the East Asian financial crisis, setbacks to the fiscal correction process, quality of fiscal adjustment, slowdown in agriculture growth affected by lower than normal monsoon years, and some slackening in the pace of structural reforms. The slowdown could also be attributed to the excessive enthusiasm and optimism in regard to investment plans in domestic industry following deregulation, which was followed by significant problems experienced in viability and competitiveness. Monetary tightening in the face of inflationary pressures is also believed by some to have contributed to the slowdown over this period. Figure-1 shows fluctuating trend in the rate of real GDP growth. There was steep decline in the rate of real growth during the period of 1991-92, 1997-98 and 2002-03 (Table-1). Since 2003-04, there has been a distinct strengthening of the growth momentum. Restructuring measures by domestic industry, overall reduction in domestic interest rates, both nominal and real, improved corporate profitability, a benign investment climate amidst strong global demand and commitment rule-based fiscal policy have led to real GDP growth averaging close to 9 percent per annum over the four-year period ended 2006-07; growth in the last two years has averaged 9.3 percent per annum (Mohan, Rakesh., 2008). The statistical analysis shows that the average real GDP growth in India during 1990-91 to 2007-08 has been 6.23 percent, while the compound annual growth rate has been 4.7 percent during the same period.
### Table-1

Real GDP Growth

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<tr>
<th>Year</th>
<th>Real GDP Growth (Percentage)</th>
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<tbody>
<tr>
<td>1990-91</td>
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</tr>
<tr>
<td>1991-92</td>
<td>1.4</td>
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<tr>
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<td>6.7</td>
</tr>
<tr>
<td>1999-00</td>
<td>6.4</td>
</tr>
<tr>
<td>2000-01</td>
<td>4.4</td>
</tr>
<tr>
<td>2001-02</td>
<td>5.8</td>
</tr>
<tr>
<td>2002-03</td>
<td>3.8</td>
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<tr>
<td>2003-04</td>
<td>8.5</td>
</tr>
<tr>
<td>2004-05</td>
<td>7.5</td>
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<tr>
<td>2005-06</td>
<td>9.4</td>
</tr>
<tr>
<td>2006-07</td>
<td>9.6</td>
</tr>
<tr>
<td>2007-08</td>
<td>9.0</td>
</tr>
<tr>
<td>Average</td>
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</tr>
<tr>
<td>S.D</td>
<td>2.15</td>
</tr>
<tr>
<td>C.V</td>
<td>34.45</td>
</tr>
<tr>
<td>CAGR</td>
<td>4.7</td>
</tr>
</tbody>
</table>

**Source:** Economic Survey, Various issues, Government of India.

**Note:** S.D=Standard Deviation, C.V=Coefficient of variance, CAGR=Compound Annual Growth Rate.

### Figure-1

![Real GDP Growth Graph](Source: Table-1)
### Table-2

**Gross Domestic Savings and Investment**

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Domestic Savings</th>
<th>Gross Domestic Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-91</td>
<td>23.10</td>
<td>26.30</td>
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<td>1991-92</td>
<td>22.03</td>
<td>22.55</td>
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<td>1994-95</td>
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<tr>
<td>1995-96</td>
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<tr>
<td>1996-97</td>
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<td>1997-98</td>
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<tr>
<td>1998-99</td>
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<td>1999-2000</td>
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<td>25.33</td>
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<td>2000-01</td>
<td>23.74</td>
<td>24.35</td>
</tr>
<tr>
<td>2001-02</td>
<td>23.45</td>
<td>23.13</td>
</tr>
<tr>
<td>2002-03</td>
<td>26.4</td>
<td>25.2</td>
</tr>
<tr>
<td>2003-04</td>
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<td>28.2</td>
</tr>
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<td>2004-05</td>
<td>31.1</td>
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<tr>
<td>2005-06</td>
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<tr>
<td>2006-07</td>
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<tr>
<td>2007-08</td>
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<tr>
<td>Average</td>
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<td>26.95</td>
</tr>
<tr>
<td>S.D</td>
<td>5.01</td>
<td>4.63</td>
</tr>
<tr>
<td>C.V</td>
<td>19.10</td>
<td>17.20</td>
</tr>
<tr>
<td>CAGR</td>
<td>2.8</td>
<td>2.21</td>
</tr>
</tbody>
</table>

*Source: CSO, National Income Accounts, Government of India.*

### Figure-2

**Gross Domestic Savings and Investment**

*Source: Table-2*
The sustained acceleration in real GDP growth of the Indian economy has been associated with a secular up trend in domestic savings and investment over the decades. Gross domestic savings has moved up from an average of 9.6 percent of GDP during 1950s to 17.5 percent during 1970s, and further to 23.4 percent during 1990s. Gross domestic savings improved marginally from 23.5 percent in 2001-02 to 37.7 percent in 2007-08. Similarly, the domestic investment rate has increased continuously from 10.8 percent in 1950s to 24.5 percent in 1990s. The gross domestic investment increased from 28.2 percent in 2003-04 to 37.5 percent in 2007-08 (Table-2 & Figure-2). The remarkable feature of these trends in saving and investment rates show that India’s economic growth has been financed predominantly by domestic savings. The recourse to foreign savings, equivalently, current account deficit, has been rather modest in the Indian growth process. However, the two decades, 1960s and 1980s, when the current account deficit increased marginally towards 2 percent of GDP, were followed by significant balance of payments and economic crises (Mohan, Rakesh., 2008).

The average of gross domestic savings and investment is 26.65 and 26.95 percent respectively during 1990-91 to 2007-08. The co-efficient of variance of savings is found to be 19.10 percent which is higher than the co-efficient of variance of investment which is 17.20 percent during the same period. The standard deviation of savings and investment is 5.01 and 4.63 respectively, meaning thereby deviation in gross domestic saving is higher than gross domestic investment, and CAGR of gross domestic savings and gross domestic investment is 2.8 and 2.21 percent respectively reflecting marginal difference in their annual growth pattern during the same period.

However, Government’s ability to invest has been declining continuously since the late 1980s because of its deteriorating fiscal position. What is encouraging, of course, is the increase in private corporate sector investment levels subsequent to the 1991 reforms. The reforms have therefore succeeded in encouraging higher level of private investment as envisaged. But further increases are constrained by declining public investment levels. Today concentration is now on the rapid deterioration of the fiscal balance both at central and state levels. The key deterrent for achieving higher economic growth in the country lies in its deteriorating fiscal performance. The key threat to substantial economic growth and to economic security is the substantial decline in investment expenditure made by the Government. The growing fiscal imbalances of the 1980s spilled over to the external sector and were also reflected in
inflationary pressures. Along with a repressive and weakening financial system, this rendered the growth process of the 1980s increasingly unsustainable. The external imbalances were reflected in a large and unsustainable current account deficit, which reached 3.2 percent of GDP in 1990-91. As the financing of such a large current account deficit through normal sources of finance became increasingly difficult, it resulted in an unprecedented external payment crisis in 1991 with the foreign currency assets dwindling to less than $1 billion. The financing problem was aggravated by the fact that the deficit was largely financed by debt flows up to the late 1980s, reflecting the policies of the time, which preferred debt flows to equity flows. Indeed, equity flows were almost negligible till the early 1990s. Moreover, a significant part of the debt flows during the late 1980s was of a short-term nature in the form of bankers’ acceptances; such flows could not be renewed easily in view of the loss of confidence following the balance of payments crisis. In response to the balance of payments crisis, a programme of macroeconomic stabilization and structural adjustment was put in place. Fiscal consolidation constituted a major plank of the policy response to the macroeconomic crisis; however, public sector savings continued to deteriorate during the 1990s, and even turned negative over the five-year period 1998-2003 owing to sharp deterioration in savings of the Government administration. The progress on fiscal correction was mixed during the 1990s at the central level. While there was some reduction in the Centre’s fiscal deficits up to 1996-97, the process was reversed over the next few years under the impact of the industrial slowdown and the Fifth Pay Commission award. Furthermore, fiscal consolidation, which was envisaged to be achieved through revenue enhancement and curtailment in current expenditure growth, was however, brought through compression of capital expenditures from 5.6 percent of GDP in 1990-91 to 3.1 percent in 1996-97, with consequential effects on growth and infrastructure constraints in ensuing years.

In view of the deterioration in fiscal deficits over the period 1997-98 to 2002-03 and rising public debt, and its adverse impact on public investment and growth, a renewed emphasis was laid on improving the health of public finances on a durable basis. In order to achieve this objective, fiscal consolidation has been guided by the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 at the Centre level. Since 2002-03, significant gains have been witnessed in the fiscal consolidation process at the Centre, partly as a result of the implementation of the rule-based fiscal policy at the Centre. A major factor contributing to the durability of the fiscal
consolidation process under way in India in recent years has been the buoyancy in the
revenues accompanied by some reprioritization of expenditure with a focus on
outcomes, unlike the expenditure compression strategy in most other countries as also
the experience in India in the 1990s. The revenue augmenting strategy encompassed
moderating the tax base and broadening the tax base through expansion in the scope of
taxes, specifically service tax, removal of exemptions, some improvement in tax
administration with a focus on arrears recoveries. Reflecting these measures, the tax-
GDP ratio of the Centre has steadily risen from 8.2 percent in 2001-02 to 11.4 percent
in 2006-07, and 11.7 percent in 2007-08 (Chapter 4, Table-3). The entire increase in
tax revenues was mainly on account of the buoyancy in direct taxes. On the
expenditure front, while the total expenditure of the Centre declined from its recent
peak of 17.0 percent of GDP in 2003-04 to 14.1 percent in 2006-07, the capital outlay
rose from 1.2 percent to 1.6 percent of GDP. The movement in key deficit indicators
reflects the progress made so far in fiscal consolidation. The fiscal deficit of the Centre
and the States taken together has declined from 9.9 percent of GDP in 2001-02 to 6.4
percent in 2006-07 led by a reduction in the revenue deficit from 7.0 percent of GDP to
2.1 percent during the same period. Apart from the quantitative improvement, a salient
feature of the fiscal consolidation under way has been some qualitative progress made
as reflected in the reduction in the proportion of revenue deficit to gross fiscal deficit.
As a result, the dissavings of the Government declined from (-) 6.0 percent of GDP in
2001-02 to (-) 1.3 percent in 2006-07. The savings of the departmental enterprises at
0.6 percent in 2006-07 were unchanged from those in 2001-02 (Mohan, Rakesh.,
2008).

However, India’s persistently large fiscal imbalances raise three concerns. First, the upward trend in the interest burden on public debt threatens the sustainability of the current macroeconomic stance. In particular, it threatens the current mix of growth and inflation. Assuming that real interest rates are equal to the GDP growth rate, solvency requires that in the long-run the primary (non-interest) public sector surplus be sufficient to finance the interest service on net outstanding public sector liabilities. This would avoid an explosive situation in which new debt is issued to cover the interest payments on the mounting stock of old debt. Because a large share of the public debt has been contracted at interest rates well below current ones, and this debt will take time to mature and be rolled over at the higher current rate, India is far from such a situation. However, in the absence of a serious adjustment in India’s tax or
spending patterns, this situation will eventually materialize forcing either inflation to increase or growth to decline. Secondly, from a public finance angle, servicing the country's public debt puts large claims on public resources, which reduce the government's capacity to spend on key development activities. In addition, it also creates a need for higher taxation, which undermines efficiency. Third, the large fiscal imbalances pose a risk to macroeconomic stability as the financial sector is further liberalized. Since a large portion of the outstanding public debt stock carries interest rates well below current market rates, the overall interest bill will increase as these obligations mature and have to be rolled over at the higher current market rates. This convergence of the average rate to the marginal rate will have a sizeable impact on public finances (Prasad, C.S., 2005).
References:


9. Ibid., P. 379.

10. Ibid., P. 245.


13. Chelliah, R.J., op .cit., p. 46.


20. Tripathi, R. N., op. cit., p.82.


41. Chelliah, R.J., *op. cit.* p. 44.


