CHAPTER I

INTRODUCTION

1. Scope of the subject:

The subject matter of this study is the relation of fiscal policy to economic development in underdeveloped countries. Fiscal policy has been used here in a broad sense. In his 'General Theory', Keynes used fiscal policy when referring to the influence of taxation on savings, and of government investment expenditures financed by loans from the public and looked at it as a State policy that uses public finance as a balancing factor in the development of the economy (1). In India, fiscal policy was generally used to mean tariff policy. The Indian Fiscal Commission of 1921-22 discussed the tariff policy of India in relation to industries. Indian economists used fiscal policy in the traditional sense of tariff policy and a noted economist like R.P. Adarkar in his well-known work 'Indian Fiscal Policy' dealt at length with commercial policy of India. The Fiscal Commission of 1949-50 also considered the same problem and examined 'the working of the policy of the government of India with regard to protection of industries since 1922' and made recommendations, among other things, regarding 'the future policy which the government should adopt in regard to protection to and assistance of industries, and the treatment and obligations of the industries which may be protected or assisted' (2).


In view of this tradition in India, fiscal policy in the present work includes a treatment of commercial policy. In a certain sense, financial policy and tariff policy cannot be separated. Indirect taxes need not be confined to domestic transactions and can be extended to imports and exports. Further, customs duties are useful fiscal instruments in many ways though as a means of development-finance they have their limitations. A discussion of fiscal policy in the context of planning has, therefore, to take into account the role of commercial policy and external finance in the scheme of development. In the sense in which we have used fiscal policy, foreign aid and domestic finance are complementary. For one thing, with the pressing problems of poverty and capital shortage, most underdeveloped countries will find it necessary to exploit both sources of capital to the utmost to achieve a sufficiently strong forward surge in productivity and break through the vicious circle of poverty and economic stagnation. For another, an inflow of foreign capital may induce, though to a limited extent, domestic capital formation. Ultimately however, foreign investment is most likely to be attracted to those countries in which domestic saving and investment thrive best and there are genuine efforts on the part of the indigenous population to go ahead with development programmes, willingly accepting the requisite sacrifice as a price of development.

As such, greater emphasis has been given to problems of public finance in the treatment of the subject. Buehler in analysing the meaning of fiscal policy said, 'By fiscal policy is meant the use of public finance or expenditure, taxes,
borrowing, and financial administration to further our national economic objectives' (3). Fiscal policy in this sense covers a broad field under which the government has to use its expenditure and revenue programmes to increase national income, production and employment, to raise living standards, to provide a richer and fuller life and to break further through the barrier of poverty which has held the people of underdeveloped countries and their economies stagnant in a swiftly developing world. That means all facts of fiscal policy are to be analysed to assist in the achievement of the economic and social objectives of plans in underdeveloped countries.

In this sense, a discussion on revenue programme merges with monetary policy. According to Professor Rolph, fiscal theory in certain aspects is applied monetary theory, and hence the monetary approach that is adopted assumes some importance. Fiscal analysis requires a theory of money to explain how various government financial measures affect private expenditures (4). For example, the function of taxation, viewed as a revenue device, is to reduce private money incomes and to increase government money income. The greater the yield of taxation, the smaller on this account is the ability of private groups to spend. Taxes are inevitably monetary deficits and to the extent that they have a yield, they reduce private cash holdings. The line of distinction between fiscal policy and monetary policy is, therefore, a thin one. In fact, they shade into one another. Further, government borrowing from

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(3) A.G. Buelher, 'Government Finance in a Stable Economy' in the Annals, 1949, p.32.

banks is one form of raising resources and it would be rather illogical to include a discussion of taxes and neglect borrowing in the treatment of fiscal policy. However, our study of monetary theory and policy here is restricted to the problem of development finance. Other aspects like interest rates or capital market which pertain directly to the field of pure monetary theory and management are neglected.

A similar kind of problem arises with price and profit policy of public enterprises. Since problems of tax policy steadily merge into questions of pricing policy for the products and services of state enterprises, fiscal policy cannot omit a discussion of these problems.

The foregoing approach shows that fiscal policy is a broad concept and in one sense it is 'economic theory as it applies to effects of government actions'. Though our analysis covers this broad field, each aspect of the problem has been studied in its relation to fiscal policy rather than as a separate and isolated phenomenon.

2. Nature of the problem:

As stated by Alfred Marshall, poverty constitutes the most important problem and the chief justification for the study of economics. In the light of this, we study the economic conditions of underdeveloped countries, compare them with those of developed ones and indicate measures to remove the difficulties so that the underdeveloped countries can make steady progress to attain self sustained economic growth. Though non-economic facts are no less important than economic factors in the process
of development (5), the analysis runs on economic lines and shows that the underdeveloped countries require a rapid accumulation of capital to increase productivity in industry, agriculture, mining etc. The central problem of economic development in all underdeveloped countries is building up capital equipment to change the structure of primitive or traditional economy into a modern industrial economy. It has been shown that rapid accumulation of capital requires a high rate of savings on the part of the people and a proper use of the savings for productive purposes. Fiscal policy is assigned the central task of wresting from the pitifully low output of these countries sufficient savings to finance programmes of economic development.

It has been our main endeavour to study the role of different agencies to mobilise savings for increasing investment. A major part of the study has been devoted to an analysis of this central problem. The discussion would show that external finance, commercial policy, borrowing from people and banks, deficit financing and profits from public enterprises could each contribute something to accelerate the process of development. But the brunt of the problem has mainly to be borne by recourse to taxation. The study has shown that improved taxation methods are a prime requirement for an increasing flow of savings.

(5) Cf R.F. Hoselitz : Non-Economic Factors in Economic Development in 'American Economic Review', Papers and Proceedings May 1957, No.2 for the importance of Non-economic factors in economic development. Joseph J. Spengler who discusses 'Economic Factors in Economic Development' in the same issue also points out, 'In back-ward countries, exogenous or non-economic factors exercise relatively most influence, the autonomy of an economic system as such increases as the society including it progresses, and therewith the applicability of economic theory'.
Taxation is the only method which can conveniently transfer resources to the government for economic development without creating an inflationary bias in the economy.

The analysis has been extended to India as a case study. The Indian experience of development finance during the first decade of planning has shown that though there is need to mobilise all possible resources, an appreciable increase in the level of aggregate savings could be attained mainly through taxation. The study here would show that so far adequate tax effort has not been made in India and if properly planned, there is considerable scope for expansion of tax revenues without injuring the incentive of the private sector.

The second problem with which our analysis is confronted is the inequality of income and wealth in underdeveloped countries. Many of these countries are characterised by extremes of wealth and poverty which constitute a compelling case for redistributive government finance. Fiscal policy in developed countries through taxation and government spending is attempting to attain a degree of redistribution which would most neatly balance (a) the humanitarian interest in sharing economic well-being more equally, against (b) the efficiency interest in maintaining sufficient inequalities in reward to serve as incentive to the exercise of special economic effort and ingenuity (6). The magnitude of the problem in these countries has become less serious in view of the fact that inequality has been reduced by a combination of increase in productivity and various redistributive policies of the government. In the case of underdeveloped countries, not only is inequality greater,

but also the machinery of the fiscal system is inadequate to tackle the problem. Further, there is the economic conflict of increasing savings with equitable distribution of income and wealth.

We have, however, tried to resolve the conflict by pointing out that if tax measures are concentrated on land rents, interest changes, luxury spending, speculation, hoarding and various types of unearned incomes, resources can be raised for development without impairing private economic activity. It has also been pointed out that capital formation in the public sector is not in conflict with private investment. If tax resources are used to increase social and economic overheads and for the establishment of key and basic industries, a progressive tax structure will not damage initiative, risk-taking and managerial efforts of the private sector. A progressive public expenditure designed to increase the efficiency of human material by providing education and training programmes and by improving sanitation, health and nutrition increases productivity and accelerates development. We have therefore emphasised the role of fiscal policy as a measure to reduce inequality and improve human well-being without sacrificing the basic requirements of economic growth. Because, what is economic growth except that it facilitates increase in per capita output so as to permit every man and woman to have a decent standard of living in the society.

The third problem with which our study is concerned is regional development. From the point of view of rapid growth, simultaneous attempt to develop all regions may sacrifice optimum requirements and scale advantages. Concentration on certain focal areas has the advantage that it provides significant
external economies, induces innovations stimulated by bottlenecks and shortages, spreads chain reaction to all sectors of the economy and thus accelerates the pace of development. But investment in 'growing points' or 'developed regions' has the disadvantage that it increases regional differences and creates political resistance to development programmes. Political harmony is the basic foundation for successful democratic planning. If the country is viewed as a unit made up of interrelated parts it is necessary that investment must be made on a broad front so that the various parts of the country can move forward in balance (7). Moreover, there must also be some internal consistency in the pattern of production. If investment occurs over a wide range of industries and regions, there is an over-all enlargement of the market as one industry or a region provides a market for another industry's or region's output (8).

Regional development, as such, facilitates economic integration which leads to political unity and harmony. We have, therefore, argued that fiscal policy should aim at regional development and as a case study we have seen the case of India where a particular machinery has been devised in recent years to bring about regional development.

The upshot of the whole discussion is that fiscal policy should be employed (a) to mobilise resources for economic development without creating an inflationary bias in the economy, (b) attain equitable distribution of income without injuring the process of growth and (c) maintain regional development without sacrificing scale advantages.


3. Layout:

The study begins with an analysis of the problems of economic development in underdeveloped countries and sets out the prerequisites of growth. We must first know what we are looking for. Accordingly we devote the second chapter to establish an analytical framework within which we have to work to discover the strategic variables in the process of development.

Next we consider the problem of resource mobilisation which is the dominant variable for economic growth. To allow perspective, we consider the role of external finance and monetary policy in resource mobilisation. The third and the fourth chapters are devoted to this analysis. It must be noted here that different factors of economic growth are not separate from one another. The study of resource mobilisation makes it necessary to stress, from time to time, the inter-relationship between different factors, i.e. resource mobilisation and its effect on the economy from the point of view of inflation, distribution of income and promotion of private enterprise. At each stage, the analysis has been extended to fields that are directly relevant to the central theme of the subject.

Our survey of external finance and monetary policy has shown that fiscal policy is very important and has a significant part to play in mobilising resources to accelerate the process of development. In the fifth chapter, we have therefore studied the implications of fiscal policy in the context of development and set down the objectives that seem to be appropriate to the institutional setting of underdeveloped countries. Against this background, chapter six opens with a discussion on the nature and scope of tax resources that should play a vital role in
changing these economies. Since public investments have been increasing in importance in planned programmes of underdeveloped countries, the possibilities of the public sector to finance economic development have been analysed in the seventh chapter.

From resource mobilisation, we have extended our analysis to the problem of development and distribution of income - the other two important aspects of fiscal policy. Public expenditure can play an important part in securing these objectives. In the eighth chapter, the significance of public expenditure in relation to these objectives has been analysed.

The final chapter analyses the importance of regional development and indicates the scope of federal finance to attain such development.

Though at each stage, India has been taken as a case study to clarify certain issues for the proper understanding of the subject, the analysis has always been presented on a theoretical plane and examples of both developed and underdeveloped countries have been taken to illustrate different issues.