CHAPTER V

FISCAL POLICY IN THE CONTEXT OF PLANNING

Changing character of Public Finance:

Prior to the great depression of the 1930s, public finance was mainly concerned with three issues: the welfare implications of government spending, equitable distribution of the tax burden, and the incidence of taxation. Except in times of war, prudent management of government fiscal affairs called for confining expenditures to the amount essential for the performance of purely governmental functions, and the raising of sufficient tax revenue to balance the government's budget. This is evident from the definition given by Dr. Dalton in his celebrated book 'Public Finance' where he says that public finance is 'concerned with the income and expenditure of public authorities, and with the adjustment of the one to the other ... ... ...' (1).

This simple approach did not very much develop the theory of government expenditures or taxation. It was explicitly stated that 'Public expenditure in every direction should be carried just so far, that the advantage to the community of a further small increase in any direction is just counterbalanced by the disadvantage of a corresponding small increase in taxation or in receipts from any other source of public income. This gives the ideal total both of public expenditure and of public income' (2). Such marginal approach in public finance reduced the importance of public financial activity and was

made to stand outside the working of the economic system. Even in case of depression, it was thought that the government could make its greatest contribution to the nation's economic health by cutting its spending (and taxing) programme to the irreducible minimum. Only in time of war was deficit financing tolerated, and after the end of hostilities the debt which had been incurred was to be reduced as rapidly as possible.

The theory of taxation was concerned primarily with the question of equity. Edgeworth, for instance, stated flatly that "the science of taxation comprises two subjects to which the character of pure theory may be ascribed: the laws of incidence, and the principle of equal sacrifice" (3).

In other words, according to classical tradition, the budget was essentially an expression of the nation's housekeeping and public finance was not fundamentally different from private finance (4).

Under the impact of depression and the advent of Keynesian economics after the publication of the General Theory in 1936, the scope of the public finance was changed and the budget was made to serve as an instrument of economic regulator. One by one all the precepts of orthodox finance were repudiated and the new fiscal policy accorded government a far more active role in the nation's economic life.

The classical economists for example, prescribed that budgets should be small and balanced in order to avoid unnecessary expansion in government activity; taxation should

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fall on consumption, i.e. mainly the poor rather than saving, i.e. the rich so as to encourage private enterprise; and public debt, if unavoidable, should be incurred only for purposes of productive investment and paid off as soon as possible by increasing taxes which impinge on current consumption (5). The economic crisis and great human suffering of the depression necessitated a change in orthodox finance and the newly established income theory of Keynes laid a solid foundation for a positive fiscal policy. The Keynesian analysis of underemployment due to deficiency in demand and incapacity of private enterprise to provide full employment challenged Say's law which implied that production always created its own market. Once it was realised that the economic system was subject to fluctuations and the private economy was not capable to maintain continued full employment which the classical economists assumed, there was need for change in government's taxing and spending policies to compensate for fluctuations in the level of income and employment. As a matter of fact, the government was permitted to increase its outlay beyond its revenue to control depression and the sanctity of balanced budget disappeared from the scene. Similarly, the idea of 'small budget' failed to impress the economist. Increased government budget was disfavoured due to the fact that taxes impinged on saving and private investment. When it was found that private investment was not directly related to saving and increased public expenditure at a time of low marginal efficiency of capital was necessary to instil confidence in business activity, hostility to large budget melted away.

(6) Ibid, pp. 85-88
The classical emphasis on taxes on consumption was based on the idea that consumption and investment were alternative ways of disposing of income and if one increased, the other was bound to decrease. Keynes showed that investment and consumption were correlated and if consumption increased, investment was sure to increase. This difference in approach was due to the fact that the classics assumed that total income and outlay were given whereas according to Keynes, they were changeable and so both could rise or fall together. Actually Keynes laid great emphasis on the role of consumption to promote economic recovery during a period of depression. This analysis allowed Keynes to exempt the poor from taxation both on 'moral and economic grounds'.

The new theory also brought about a revolutionary change in the attitude towards public debt. Keynes welcomed an increase in public debt in order to increase national income. Increase in public debt was interlinked with increase in deficit budgeting and the latter was supposed to create income by the process of multiplier. Keynes tried to demonstrate that an increase in investment financed by the creation of bank credit would raise the national income not merely by an equal amount, but by a multiple of the increment in investment. This multiplier concept had a magic effect on economic thinking. It is probably due to this that most of the economists started thinking that deficit financing would eliminate depression from the economic system and therefore, accepted increase in public debt as a salutary provision. The new formulation also supported borrowing for non-productive purposes. If capital accumulation was as productive as consumption, because increase in consumption was also responsible for increasing investment, borrowing for consumption was as desirable as borrowing for investment.
Role of public finance in underdeveloped countries:

The Keynesian economics also influenced thinking in respect of underdeveloped countries and the States were called upon to play an important part in maintaining economic stability and promoting economic development. In view of the fact that direct commandeering of resources was fraught with grave danger, indirect methods of control and regulation were considered essential for underdeveloped countries to maintain efficiency and secure democratic rights and privileges for the people. Public finance was considered a suitable method for this purpose.

Secondly, for raising resources for economic development public finance assumed a new significance. The underdeveloped countries were characterised by low savings and the private sector was not in a position to realise more savings either by reducing wages or by increasing inequality of income. The example of early capitalism to achieve high rate of profit by reducing wages, or increasing inequality was no longer possible due to change in the temper of time. Nor was it desirable to follow the communist method of directing resources for the production of capital goods and keeping the consumers at the subsistence level. The States in underdeveloped countries were, therefore, compelled to raise public savings through fiscal policy.

Finally, for the purpose of direction of the private sector which continued to be an important element in the economic system of the underdeveloped countries, public finance assumed a new role. In case of India, for example, inspite of the increasing role of the government in accelerating the process of development, the private sector could not be sacrificed or neglected in the field of economic activity. Not only the capacity of the State was limited in generating sufficient development, the existence
of the private sector was also necessary for maintaining a viable system of economic organisation. This does not however mean that private sector should have a free hand in allocating its resources. For the sake of the realisation of planned targets, the private sector should fit in with the objectives and priorities of planned economy. Fiscal policy is an important instrument in guiding the pattern of investment in accordance with these policies.

**Objectives of fiscal policy in developed economies:**

The main objective of fiscal policy in developed countries is to maintain economic stability. Economic growth in short period is more or less autonomous. Fiscal policy may not, therefore, be directed to attain economic growth. 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' (6). In the short period, the economy may be subject to cyclical fluctuations, but since the fluctuation may take place around a rising economic trend, the public authority may try to attain economic stability by regulating the flow of purchasing power. That may be a sufficient condition to create necessary environment for smooth economic progress.

Besides short term instability, there may be a long-run disequilibrium in mature economies. The analysis of Harrod and Domar in respect of secular growth shows that there might be a long-run disequilibrium in mature economies as contrasted with short-run instability of Keynesian type. This long-run instability may arise when income does not grow at a rate just sufficient to insure the full-capacity use of a growing capital stock. Harrod

and Domar assign a crucial part in the process of growth to capital accumulation. According to them, capital accumulation has a double role: on the one hand, investment generates income, on the other, it increases the productive capacity of the economy by enlarging its capital stock. Since Keynes was interested in the short run, he assumed that the stock of capital is given and did not consider the longer run problem of the increasing productive capacity which results from investment (7).

Once it is assumed that investment is likely to increase the economy's productive capacity by enlarging its capital stock, there is a possibility of long-run disequilibrium unless real income and output expand at a rate proportionate to that at which productive capacity of the stock of capital is expanding. This long-run disequilibrium may be either secular inflation or secular depression. To use the model of Harrod, if G, the actual rate of growth becomes greater than G_w, the warranted rate of growth corresponding to full capacity growth rate, there arises secular inflation. This is because income grows at a rate faster than what is allowed by the growth in capacity, leading to a deficiency of capital goods and increasing pressure on capacity. If on the other hand, G < G_w, there arises excessive capacity, leading to fall in investment, employment and income.

It is, therefore, necessary that G should be made equal to G_w to maintain long-run stability. However, though G = G_w is a necessary condition of long-run equilibrium, it is not a sufficient condition (8). In order to ensure full

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employment rate of growth, we should introduce $G^*_w$, the natural rate of growth of Harrod. The natural rate of growth is the maximum rate of growth which will ensure full employment to a growing labour force in the context of rising productivity of labour due to technological development. If $G^*_m = G^*_w = G$, there is full employment equilibrium growth. If not, there is disequilibrium.

In such a case, there is need to bring about equality between these different growth rates to assure stable economic growth. The objective of fiscal policy in the long-run is, therefore, long-run economic stability. The short-run stability has, therefore, to be dovetailed into the long-run and fiscal policy to be oriented to promote economic stability in order to maintain a stable rate of growth. If the Keynesian and post-Keynesian analyses are accepted, both in the long and short periods, it may be the role of fiscal policy to reduce the proportion of saving to national income and increase the rate of consumption. Keynes was of the opinion that depression is the characteristic feature of mature capitalistic economies and the reason is excess saving due to increased income. Harrod also points out that in the process of secular growth, $\delta$ is likely to be greater than $G^*_n C^*_n$. In that case, there is a possibility of secular stagnation. The requirement of stability would, therefore, require reduction in the ratio of savings to national income and increase in the proportion of total consumption (9).

(9) If on the other hand, there would be tendency towards inflation, both in the short and long-run, consumption had to be curtailed to achieve economic stability. Thus, in a developed economy, $\delta$ has to move up or down according to circumstances.
The nature of instability in underdeveloped countries:

The underdeveloped countries are as much subject to economic fluctuations as industrial countries. But the nature of fluctuation is very different. Firstly, the fluctuation of the economy in underdeveloped countries is at a low level of income and there is no scope for stable growth in the economy. Maintenance of stability cannot, therefore, bring about economic progress. Another feature of economic instability in these countries is that there is greater fluctuation in income and price than in employment and output. Though income in underdeveloped countries is low, there are surprisingly large oscillations in income in contrast with moderate amplitudes of fluctuations around a high national-income trend of industrial countries (10). This is particularly due to lack of diversification in the economy. The preponderance of agriculture in the economy makes supply relatively less elastic and unemployment less acute, but makes prices and income more vulnerable to business conditions. For example, when depression strikes an underdeveloped economy, there is some rise in open unemployment, but most of the labourers displaced from industries fall back on agriculture, thus increasing disguised unemployment. This reduces income and prices eventhough agricultural production does not show any significant change.

Moreover, the major fluctuations do not always originate in underdeveloped countries. They originate in the more advanced countries and are then transmitted to the less advanced through foreign trade transactions. As has already been shown, many of

the underdeveloped countries derive a substantial part of their national income from the export of a few primary products. When there is a fluctuation in foreign demand, the internal economy cannot escape the vicissitudes. Even a country like India where exports do not form a high proportion of total output, external demand seems to exert an important influence on the internal price level (11).

Finally, in a mature economy where the level of income is high and capital structure is large, the marginal propensity to save is likely to be greater. This tendency may reduce effective demand and create a deflationary situation for the economy. On the other hand, an underdeveloped country with low levels of income and capital structure may increase marginal propensity to consume and thus create an inflationary situation. This inflation is different from the inflation that might occur in developed countries. There is underemployment, low order of resource utilisation and inflation in the economy.

Objectives of fiscal policy in underdeveloped countries:

In view of the peculiar characteristics mentioned above, it follows that stability in underdeveloped countries cannot be separated from economic growth. These economies require a steady rate of growth in order to overcome large fluctuations in income and prices. Economic stabilisation is, therefore, a special case in the problems of economic growth. This changes the nature of the budgetary policy. Since there is little correlation between increase in monetary expenditure and utilisation of idle resources and the nature of unemployment between developed and underdeveloped *(11)*

countries is different, an attempt to increase employment may not bring about economic stability in these countries. In the context of underemployment, inflationary pressure and low level of income, the goal of fiscal policy should be the promotion of the highest possible rate of capital formation. Growth-plus-stability presents a more challenging problem than a merely compensatory fiscal policy. The way to do it through fiscal policy would be to raise the level of aggregate saving in the community and reduce the actual and potential consumption. Therefore, in underdeveloped countries, the theory of functional finance loses much of its significance. The government has to follow a policy of 'Activating Finance' and try to increase resources for increasing economic development (12).

Besides the development of resources and avoidance of inflation, fiscal policy should be directed to guide the allocation of existing resources into socially necessary lines of development. It is true that fiscal policy in the context of planning cannot be tied down to a rigid notion of scarcity and the consequent inter-industry allocation of resources. The approach should rather be an increase in productive resources on a basis of inter-temporal allocation of resources. Productive resources are, within limits, elastic and capable of being used in ways which accelerate the growth of an economy (13). However, in the absence of automatic increase in productive resources and rigidity in economic structure of underdeveloped countries, fiscal policy should be used to make existing resources gravitate towards the desired areas of investment. Particularly

when the autonomous tendency of resource utilisation is unsatisfactory, the need for fiscal policy to attain a socially optimum pattern of investment is indispensable.

Fiscal policy should also aim at an equitable distribution of income and wealth in the society. Unlike developed countries, there is a wide gulf of difference of income between the rich and the poor in back-ward countries (14). Existence of such gross inequality in income distribution is a social malaise and no measure of economic development would increase economic welfare unless an equitable distribution of the rising national product is assured. However, this is one of the areas of welfare economics which involves value judgments and quantitative thinking is not easy to apply to this field. Again, there is a feeling that a deliberate programme of equalisation of income would stand in the way of economic development and destroy incentives for growth. If it is accepted that people with higher income have greater capacity to save and accumulate than people with lower income, equitable distribution of income may reduce the volume of saving and investment and thus retard the rate of growth. It is, therefore, difficult to say to what extent inequalities should be reduced. This does not, however, mean that fiscal policy should neglect this problem. Reduction of inequality rates high in social programmes of democratic countries and a government can lose sight of it only at its own peril. Moreover, this is not correct to say that optimum rate of growth and maximum social welfare are irreconcilable. If we can formulate a well-balanced fiscal programme, a satisfactory reconciliation is not impossible of achievement.

(14) This has been discussed in detail in Ch. VIII.
If the instability in underdeveloped countries is due to the exposed character of their economy, fiscal policy has an additional role of protecting the economy from unhealthy developments abroad. As we have already seen, most of the poor countries are characterised by (a) a heavy dependence on foreign countries for capital goods and/or foodstuffs, (b) dependence on the export earnings of one or two commodities, both as a source of national income and as a source of foreign exchange, and (c) a dominant position of foreign investment in their primary industries combined with a tendency of investors to remit profits abroad. Such difficulties cannot easily be rectified in short periods. Ultimately, the way to reduce the exposure of underdeveloped countries to the ebbs and flows of world markets lies along the path of diversification and balanced economic development. If fiscal policy facilitates capital formation, it serves at the same time to reduce instability. However, along with capital formation, some specific measures for controlling imports, increasing exports and increasing agricultural production, especially foodstuffs may have to be taken to make these countries less vulnerable to the fluctuating world market conditions. Fiscal policy may play an important part in achieving these objectives.

It seems reasonable to conclude from the above analysis that fiscal policy should have the following important objectives: first, to make available for economic development the maximum flow of human and material resources consistent with minimum current consumption requirements, second, to maintain reasonable economic stability in the face of long-run inflationary pressure and short-run international price movements, and third, to reduce, where they exist, the extreme inequalities in wealth,
income and consumption standards which undermine productive efficiency, offend justice, and endanger political stability (15). These objectives may seem to be similar to allocative efficiency, economic growth, stability and optimum income distribution which guide fiscal policy in advanced countries. But the ordering of priorities are so different that fiscal policies take different lines in different countries. For example, when there is inflation in an advanced industrial economy, the contracyclical fiscal policy requires a net budgetary adjustment in shape of an overall surplus. A chronic inflation needs curbing through continuous overall budget surpluses (16). But the control of inflation in an underdeveloped country needs to be dovetailed with the growth of the economy. The fiscal policy for growth plus-stability probably requires a contra-cyclical variation of public receipts with an upward bias of public expenditures for economic growth.

Another significant point needs clarification. One of the most important characteristics of fiscal policies is that they are aggregative in character, that is, they are intended to influence such magnitudes as the total volume of economic activity, the general level of prices, and the total of consumer spending (17). But since the economies of underdeveloped countries are not

(15) Taxes and Fiscal Policy in Underdeveloped Countries, op.cit.,
(16) Budget surpluses in all cases may not reduce inflationary pressure. 'Surplus financing' like 'deficit financing' may be inflationary, if consumption expenditure was not reduced. This is more so in underdeveloped countries where consumption propensity is high and misdirected investments cover very small real resources. What is important is not the size of surplus, but its nature. Surplus financing must be through taxation or borrowing of genuine consumption funds and not merely, of loanable or misdirected funds. In the short run, bottlenecks, like inelastic primary production, etc. of low-income economies should be taken as 'data'. See H.R.Somers, 'Public Finance and National Income', 1949, pp. 514-535.
sufficiently diversified and lack of communication between different sectors is pertinent, an aggregative approach may not be effective to achieve the objective. For example, the spectacle of the co-existence of inflation and unemployment in Indian Economy belies the theory that true inflation starts only when full employment of labour is reached. An aggregative approach in the sense of the development of the economy may increase production, reduce the pressure of unemployment and lower the general price level, but still there might be inflationary pressure in different sectors. To remove such sectoral imbalances, steps should be taken to remove frictions and immobilities hindering the free movement of factors of production, by proper direction of demand, organisation of the labour market and the elimination of 'bottlenecks' by rectifying horizontal and vertical maladjustments in the structure of production. It is, therefore, necessary that both aggregative and segmental approach should be combined to meet the problems of development-plus-stability.

Mechanics of fiscal policy:

The above analysis shows that to reach any of the objectives of fiscal policy, there should be a minimum level of growth in underdeveloped countries. That means, attempt should be made through fiscal policy to increase the rate of growth by raising additional resources for capital formation. A rapid accumulation of capital requires, as we have already seen, a high rate of savings on the part of the people and a proper use of the savings en-tce for productive purposes. Before we consider different methods of resource mobilisation, let us first note that raising resources has two features: first to transfer funds (and thereby real resources) of the proper magnitude to the government for the government's use, particularly to finance
government expenditures for economic development, and second, to transfer savings from the private to the government sector and vice versa to assure their most productive utilisation. The method that should be followed in this connection should be such that in the process of development, the per-capita level of consumption of the poor mass should at no time fall below the initial level. In view of the very low standards of living of the masses of the people, curtailment of consumption from the existing low level of income would impair efficiency and create injustice. This means that attempts should be made to restrain the consumption of non-essentials to the extent that would provide sufficient resources for economic development. To do this, fiscal policy should be used to mop up a great part of the surplus income which is at present wasted in unproductive consumption. 'A person's income can be said to contain a surplus if it is above the level needed to maintain the minimum consumption necessary for efficiency and for incentives' and the purpose of fiscal policy should be to mobilise this surplus for economic development (18).

Besides, a rising proportion of additional output arising out of initial development should be collected for capital formation (19). If increase in consumption is proportionate to increase in income, internal resources can never be sufficient to increase economic development.

(18) Fiscal Policy in Underdeveloped Countries, op.cit. p.66.

The method of resource mobilisation should not also impair genuine private investment. Since public and private sectors are to be co-ordinated to increase the tempo of development, fiscal policy should be delicately handled to maintain proper balance between the two sectors. In accordance with the principles of 'Activating Finance', fiscal policy should have the goal of raising resources for economic development and like 'Functional Finance', it should provide incentives to private production and limit unnecessary consumption.

Finally, a deliberate policy of inflation should not be adopted to increase resources for capital formation. In a situation where inflationary pressure is great, resource mobilisation through deliberate inflation may injure the private economy and inflict considerable hardship on the people who do not have the capacity to bear it. If it is accepted that the main objective of fiscal policy is to attain economic growth with stability, creation of deliberate inflation does not seem to be the proper route for expansion.

On the basis of these principles of resource mobilisation, the utility of different methods may now be examined. There are three methods by which the government can raise resources. They are taxes, borrowing from the public and commercial banks and borrowing from the Central Bank, which is called deficit financing. Of all the three, deficit financing is the most controversial and economists are sharply divided as to its utility for financing investment in backward economies. Let us, therefore, examine in detail the meaning and scope of deficit financing in underdeveloped countries with special reference to India.
The technique of deficit financing:

As has been indicated, the technique of 'Deficit Finance' was popularised by Keynes to increase employment and output during a period of depression. The concept was the product of the following propositions:

(1) An advanced industrial economy may not automatically come into equilibrium at full employment. At any time, the volume of private investment may be inadequate to maintain a high level of income and employment, given the prevailing distribution of income and the consumption pattern of the community.

(2) The traditional remedies for depression—cuts in wage rates and decrease in interest rates—are not adequate. Wages are both costs and the effective demand of wage earners. Stimulus due to reduction in costs may be offset by decrease in consumers' demand. Investment is not interest elastic.

(3) In such a situation, if a given volume of investment is undertaken by the government through deficit spending, it will give rise to income which is a multiple of initial investment. In other words, an increase in investment leads to successive increments in consumption and the combined effect of increase in investment and successive increments in consumption increases national income more than the increase in investment.

Neither this analysis nor the economic effects of deficit financing were entirely satisfactory (20). Even the magic concept of the multiplier was subject to a number of limitations.

For example, the successful working of multiplier depends on the fact that the new investment must be maintained. One injection of new investment will raise the national income to the multiplier value but as soon as the multiplier effect has worked itself out, the national income will fall back to its original value. Only a steady injection of new investment will, after a time, raise national income to the multiplier level and keep it there.

Secondly, there is a time lag between the receipt of income and the spending of it and also between the spending and its reappearance as income. That is, the consumers who receive additional income due to increase in investment are not likely to re-spend it immediately. Further, the period analysis gives rise to the possibility of leakages. All the income received may not be consumed, a part may be saved, another part may be used to pay off old debts, a third part may be used for charity or relief payments (21). Finally, there may be also cyclical variation in the marginal propensity to consume and thus create instability in the value of the multiplier (22). However, in spite of these limitations, it was taken for granted that a programme of expenditures financed by deficit financing was likely to have a greater net expansionary effect upon the economy than a programme of the same magnitude financed by taxation. Therefore, deficit budgeting was accepted as a sound budgetary policy in most of the States.

(21) Keynes, of course, mentioned some of these limitations but in his enthusiasm for the new concept, he did not attach much importance to them.

Keynes, however, confined his attention to the multiplier effect of deficit budget. Increase in investment and the successive re-spending of the new income give rise to the multiplier effect. But the secondary expenditure on consumption may induce further increments in investment. The ratio between a net increase in consumption and investment induced by this increase in consumption has come to be known as the relation or acceleration co-efficient (23). The measurement of the full effect of investment expenditures on income should take into account both the multiplier and the acceleration principle; otherwise, the effects of autonomous increases in investment on national income would be incomplete.

Samuelson has combined the multiplier and the relation (24). His study shows many interesting results. His conclusions can be summarised as follows: (i) If we take into account only the multiplier effect (i.e. assume relation to be zero), a steady injection of new investment leads to a steady rise in national income equal to the value of the injection times the multiplier, (ii) With a new steady investment of Rs.100 and marginal propensity to consume of .5 and in addition, a relation of unity, the national income is seen to rise to the Rs.200 level very much more quickly than if the relation is zero. But at the same time, we get damped oscillations about the income level obtained from the multiplier effect alone; (iii) With higher values for MPC


and the relation, the fluctuations in national income occur with increasing amplitude around the average value, the average value being equal to the income level which the national income would attain on the basis of the multiplier effect alone; (iv) Finally, if we allow the values of the MPC and the relation to go still higher, especially if the latter is allowed to approach 4, we get no oscillations, but get instead explosive effects, the national income rising constantly and at a rapidly increasing rate. Were these high values for the marginal propensity to consume and the relation to persist, a runaway inflation would be in evidence as soon as full employment began to be approached.

This analysis shows that the principle of acceleration does not play an important part in the determination of national income. All that it does is that it speeds up the rate at which the national income reaches the level indicated by the multiplier effect alone. Here again, it is responsible for fluctuations which the national income displays in reaching the level indicated by the multiplier effect alone. It is only in the special case of high leverage values that acceleration principle has some effect in lifting national income (25).

**Deficit-Financing in Underdeveloped Countries**: If the multiplier effect of deficit financing in an industrially advanced country can lift the economy by increasing employment and income in a state of depression, what is the effect of deficit financing in an underdeveloped country?

(25) It is for this reason that Hansen says that there is no possibility (except for the case of high leverage values) of raising the income to higher and higher levels by the process of lifting yourself by your bootstraps via the interrelation of increased consumption and increased investment in the familiar expansionist process. See A.H.Hansen: Fiscal Policy and Business Cycles, W.W.Norton 1941, pp.283-284.
To begin with, let us consider the definition of deficit financing in developed and underdeveloped countries. In the United States, the term deficit spending or deficit financing is generally used to mean any expenditure by the government that is in excess of its current revenues. Hence expenditure that is financed by borrowing from the public is included in the measure of deficit in the budget. In India, however, deficit financing has been treated mainly in terms of an expansion of currency (26). That is, the expenditure financed by borrowing from the public and commercial banks (in governmental accounting practice, borrowing from the public and from the banks are lumped together as 'market borrowings') are excluded from the measurement of deficit. Deficit financing, therefore, includes three things: (a) borrowing from the Central Bank, (b) withdrawal of cash balances and (c) issue of new currency by the government. Since in India, the last method is not usually employed, except in case of one rupee notes amounting to Rs.5 crores per annum, deficit financing in India comprises the first two (27).

Deficit financing in this sense is more inflationary than borrowing from the public or banks. Borrowing from the public may be genuine savings. The borrowing from banks which expands credit may also be limited by the cash resources of the banking system. Creation of currency due to deficit financing


(27) Analytically, financing additional public expenditure by drawing down past accumulated balances is equivalent to borrowing from the Central Bank since in both cases the funds arise outside the current income stream.
adds to the cash resources of the banks and enables them to bring about a much greater expansion of credit. Moreover, the credit of banks has a self-liquidating character. But it is not so with regard to created money. If the government creates money against its own securities, the government cannot 'sell these securities to the public without at the same time impairing public credit and raising the rate of interest with deleterious consequences on its own development programme as well as on private development programme' (28). It follows that central-bank-borrowing form of money creation is likely to feed the inflationary fires.

Moreover, the multiplier effect of deficit financing is likely to be weak in underdeveloped countries. There is the difficulty of transforming latent resources into actual output due to the rigid character of their economies. Inspite of the fact that there is a large volume of underemployment and unemployment in the economy, increase in monetary demand does not increase production due to lack of capital equipments and other complementary factors associated with them. These complementary factors are lack of entrepreneurship, lack of technical knowledge, lack of adequate economic organisation and market communications, lack of economic and social overheads and so on and so forth. A common factor of all these obstacles is that they relate to deficiencies of effective supply rather than effective demand. This deficiency leads to


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(28) Dr. V. K. R. V. Rao : Deficit Financing, Capital Formation and Price Behaviour in an Underdeveloped Economy, Indian Economic Review, February, 1953. Dr. Rao has discussed in detail how deficit financing in the sense of creation of money is more inflationary than borrowing from banks.
low productivity and low elasticity of supply. Hence an increase in effective demand does not easily lead to an increase in the volume of output and level of employment. On the other hand, it exhibits itself in the form of higher prices.

It may be said that if the supply elasticities are not zero, an increase in effective demand is likely to increase production. Moreover, all parts of the economy are not equally elastic. For example, the supply elasticity of agriculture is much lower than that of industries. If this is so, what is the justification of saying that an autonomous increase in aggregate expenditure would give rise to a general increase in prices?

There are many reasons for this. Firstly, there is 'the disturbing effects of low supply elasticities on the distribution of income' (29). If supply elasticities of certain parts are low, these parts of the economy are likely to enjoy a level of income substantially above average income due to increase in deficit spending, because an increase in aggregate expenditure will be concentrated in that part of the economy where supply elasticities are low. In that case, it is doubtful whether 'prices (and income) can remain stable in the 'suffering' part of the economy in the face of sharp price and income gains in the other part'.

Secondly, an increase in income is likely to increase the demand for food articles. In an underdeveloped country, the demand for food is disproportionately high. In India, the expenditure on food forms not less than 63 per cent of total expenditure. Moreover, recent experience shows that when there

is the availability of cheap profits. This lowers the standard of commercial morality, dulls incentive to efficiency, enlarges the field of operation of the middle-men and the broker and diverts talent and personnel from production to non-productive speculation. On the whole, businessmen during a period of inflation, seek to get profits by manipulating markets instead of trying to invest in risky projects and increase in production.

This shows that there is a strong case for playing safe with inflationary financing in under-developed countries. Though it has to be used for increasing capital formation, it must be kept within safe limits so as not to generate what may be called 'elastic expectations'. The following precautions seem to be in proper order. Firstly, inflationary pressure should be counteracted by direct and physical controls like price control and rationing of essential commodities. There is, of course, a danger that repression inflation would lead to a 'corruption' inflation. The government machinery should, therefore, be improved for efficient working of these controls, because without these controls, people will lose confidence in the country's currency and inflationary financing might lead to cumulative inflation.
Along with this, the machinery of tax collection should be improved to mop up the marginal increases in income. No government should think of deficit financing unless it has the capacity to collect a large part of the increased income by way of taxes. Controls can only bring about an equitable distribution of income, but they cannot reduce the pressure on demand. Taxation is the only method to reduce the pressure of demand and decrease the inflationary pressure in the economy. In the U.S.S.R. when the economy was transferred from a 5 per cent to a 20 per cent net saver, there was a tremendous price inflation (prices rose about 700 per cent in a decade), but the government with its very high rate of turnover tax automatically mopped up surplus funds injected into the system before they were able to generate much demand inflation. The high marginal rate of taxation in the U.S.A. and the U.K. was able to control inflation during the war time - the tax system sucked up 50 per cent or more of expenditure as fast as income was generated. Underdeveloped countries cannot escape inflation without increasing their marginal rates of taxation (46).

(46) Dr. Rao has pointed out that if the size of deficit financing is small and some part of the newly created money consistently comes back to the government in taxes, it can be profitably used for economic development. See Deficit Financing, Capital Formation, & Price Behaviour in an Underdeveloped Economy, op. cit.
Moreover, inflation to succeed as a method of capital formation should be used 'only intermittently and in small doses' (47). There is a great danger in inflation that it tends to become cumulative without any possibility of immediate abatement. If monetary authority, instead of continuously increasing the money supply, alternates short periods of monetary expansion with sharp periods of restriction, confidence can easily be maintained. If bank credit moves three steps up and one step down, instead of moving upwards continuously, the creation of new money contributes, as Lewis remarks, towards capital formation without provoking runaway inflations, and without seriously affecting people's confidence in money and in government bonds.

Finally, inflationary investments should be such that they should be productive and can be completed very quickly. A creative inflation is one which is used for productive activities. Without an adequate increase in the production of food and other basic materials to ensure the minimum standard of living for the people, inflation may have dangerous political and economic implications for the country. Moreover, the time necessary to complete the process of investment and produce output is also important. If inflationary investment is of the type that Hicks calls 'quick investment' having a short

'fruition-lag' and a high 'fruition co-efficient', the inflationary effect on prices will soon peter out, and prices will rapidly come down (48). It follows, therefore, that productive public investment directed towards increased supply of basic goods in the more immediate future provides the classical case in defence of deficit financing.

Scope of deficit financing in India:

Deficit financing has played an important part in India in financing development. In the first five year Plan period, the total amount of deficit financing was to the extent of Rs. 420 crores. As compared to the estimated plan outlay of Rs. 1960 crores, deficit financing worked out at 21 per cent of the total outlay. Over 60 per cent of the deficit financing was accounted for during the last two years of the plan period (49). In the second five year Plan, deficit financing accounted for as much as Rs. 1175 crores - its proportion to total outlay being about 25 per cent (50).

Such continuous deficit financing by the government along with loans from commercial banks has expanded the public and private credit and has resulted in an enormous increase in the money supply with the public. During the first Plan period (1951-52 to 1955-56) the total increase in money supply was


(49) Review of the First Five Year Plan, May 1957, p.34.

(50) The original estimate was Rs. 1200 crores. The latest figures indicate that deficit financing would be a little lower than Rs. 1175 crores. See Budget of the Government of India 1961-62, Reserve Bank of India Bulletin, April 1961.
Rs.198.7 crores; there was a substantial decline in the first two years, after which there was a progressive increase, the rise in the last year (1955-56) alone being Rs.264.3 crores. The government sector accounted for an increase of Rs.245.2 crores, while the private sector for Rs.106.0 crores. During the second Plan period (1956-57 to 1960-61), the total increase in money supply was Rs.722.4 crores. The expansion in money supply took place during all the five years, the largest rise of Rs.204.9 crores being in the year 1959-60. The government sector accounted for an increase of Rs.1400.5 crores while the private sector for an increase of Rs.49.7 crores (51).

A detailed analysis of the impact of the government sector on money supply shows that during the first Plan period the impact was negative during 1951-52 and 1953-54; it was, however, substantially expansionist during the last two years, the expansion of Rs.194.8 crores during the last year (1955-56) being the largest. During the second Plan period, the increase in money supply on account of the government sector was quite substantial in all the first four years; it was the largest (Rs.502.0 crores) during 1957-58, after which it became progressively smaller (52).

Such an increase in money supply had its effect on the price level in the country. During the first five year Plan, the inflationary impact of public and private credit was not felt due to the existence of surplus sterling balances, excess capacity in industries, comfortable availability of food supplies and low level of imports of machinery till the end of the Plan. In other words, the tempo of development was slow to

(52) Ibid, p.1061.
begin with. But prices started rising since the middle of 1955 and continued to rise in the following years. The following table gives the trend since 1956.

**TABLE V - 1**

Index Number of Wholesale Prices.

(Base 1952-53 = 100)

<table>
<thead>
<tr>
<th>Groups</th>
<th>March 1956</th>
<th>March 1959</th>
<th>March 1960</th>
<th>March 1961</th>
</tr>
</thead>
<tbody>
<tr>
<td>All commodities</td>
<td>98.1</td>
<td>112.4</td>
<td>118.9</td>
<td>127.5</td>
</tr>
<tr>
<td>Food articles</td>
<td>92.8</td>
<td>113.8</td>
<td>117.0</td>
<td>117.5</td>
</tr>
<tr>
<td>Industrial raw materials</td>
<td>109.4</td>
<td>116.2</td>
<td>113.9</td>
<td>159.1</td>
</tr>
<tr>
<td>Manufactures</td>
<td>102.9</td>
<td>108.6</td>
<td>116.9</td>
<td>129.4</td>
</tr>
</tbody>
</table>


Table V - 1 shows that there was a continuous rise in prices during the period of second five year Plan. Over the second Plan period, the general price level recorded a rise of 30 per cent, which contrasted with a decline of 18.4 per cent during the first Plan period. Except for a slight decline of 0.2 per cent during 1957-58, there was price increases in each of the remaining four years, the rise being 7.6 per cent in 1956-57, 6.6 per cent in 1958-59, 5.8 per cent in 1959-60 and 7.2 per cent in 1960-61.

This general uptrend in price level reflected the pressure of continued expansion in bank credit and money supply in the country. Had there been better organisation in improving the production of basic goods like food grains and industrial raw materials or distributing available supplies in all centres, the rise in price level during the second Plan period could have been checked in spite of increased deficit financing and
money supply in the country (53). But these were factors which could not be improved in an underdeveloped country like India within a period of five or ten years. Again, had there been considerable improvement in monetisation of the economy, the increased supply of money would have been absorbed in the economy and the price increase would have been moderate. But the rate of monetisation in India is considered to be about one per cent per annum (54).

That means, there is not much scope for deficit financing in India at the present stage of the economy. The planners have realised this and reduced the size of deficit financing from about 25 per cent in the second Plan to less than 8 per cent (₹550 crores of deficit financing with a total planned outlay of ₹7500 crores) in the third Plan. Whether this will be a safe limit or there will be a need to increase or decrease the size of the deficit would depend on the general economic condition prevailing in the country and particularly on the growth of output of basic consumption goods. However, the experience of the second Plan period shows that there is need for caution in using this technique for resource mobilisation and economic development.

Importance of public debt:

If deficit financing has to be kept within limits, there is a great need to increase borrowing for financing development. Without sufficient public debt, the tempo of economic development cannot be maintained in underdeveloped countries. While a

(53) According to Dr. M.H. Gopal, the major factor in rise in price-level during the second five year Plan was organisational and administrative factors. See 'Recent Price Trends and Monetary Factors - A Reassessment', Commerce A.N., December, 1959.
(54) Analysis of Money Supply in India, op. cit. p. 1046.
programme of development financed by borrowing is likely to have a greater net expansionary effect upon the economy than a programme of the same magnitude financed by taxation, it would not be as inflationary as deficit financing. The common statement that 'borrowing is inflationary' is misleading. If the government increases borrowing from the public, it might curtail either consumption or business investment or absorb idle balances. If idle balances are activised, there might be some expansionary effect on the economy. But if individuals purchase government bonds out of funds that would have been used to buy other securities, there is a diversion of resources which may tend to depress security prices, raise the rate of interest, make the sale of additional stock more costly to corporations and thus may indirectly produce contractionary effect on the economy. Similarly, if public borrowing reduces consumption, the inflationary impact of the public debt is minimised. That means there is no guarantee that public debt in each and every case will necessarily lead to inflation.

What is necessary in an underdeveloped country is that efforts should be made by the government to encourage people to save more and to discourage unproductive expenditure on say, gold or ostentatious residential construction. The pattern of people's tastes is the product of tradition and social custom, and it may take years of persuasion and education to induce people to give up the prevalent forms of wasteful consumption and increase saving for capital formation (55). But that has to be done in the interest of the economy. A number of suitable intermediate agencies should be established which can attract savings from the people and loan them on to the

A complex structure of savings banks, commercial banks, insurance companies, social security institutions, etc. can provide a more varied incentive to people to save and relieve them of many difficult decisions about how and where to invest (56). Much remains to be done in this field in many underdeveloped countries. Another method is to start self-help local work projects. If the projects are simple and they give direct benefits to the locality, people of the region might be induced to restrict consumption in order to provide the wherewithal for the undertaking.

However, these voluntary savings from individuals cannot be sufficient in the initial stages of development and the government will have to raise loans from different financial institutions. If loans are raised from non-bank financial institutions like insurance companies, mutual savings banks, etc. the expansionary effect is negligible. When they buy government bonds, in part they may simply reduce their cash balances. But in large measure they are likely to buy the government bonds instead of other securities. Only when loans are raised from commercial banks, there is some expansionary effect on the economy. If the commercial banking system has excess reserves, it can absorb an amount of government bonds considerably greater than excess reserves, without curtailing other loans. The purchasing power to buy bonds is essentially created rather than being merely transferred. Accordingly, the programme produces some expansionary effect. On the other hand, if the banks do not have excess reserves, they cannot buy government bonds without curtailing other loans, and the effect of the sale of bonds to them is much the same as that of the

(56) Ibid, p.211.
sale to other financial institutions (57).

It does not follow, therefore, that the net effect of public debt is always inflationary. Actually, there should be a distinction between expansionary effect and inflationary effects of public debt. If increase in public debt does not produce any expansionary effect, its purpose is defeated. It should activate idle money and/or increase the quantity of money to finance new developmental projects. But even the expansionary effects of public debt does not depend on creation of public debt. The expansionary effects of a borrowed-financed programme are due basically to the expenditure of the funds rather than to the borrowing itself (except in part when the bonds are sold to the central banking system) (58). If the borrowed funds are utilised to increase aggregate productive capacity, there is no danger of inflation in the economy.

The real source of the inflationary potential has to be sought, not so much in the process effects of public debt as in the asset effects (59). Ownership of an increasing volume of financial capital undermines the incentives to save and raises the propensity to consume, the higher level of demand being directed particularly towards luxury and conspicuous consumption. Individuals who hold the bonds consider these to be portions of their personal wealth, which they would not have if the government expenditures had been financed entirely by taxation, but they are not likely to take into consideration the claims which the bonds represent against them as tax-payers. As such,


their desire to spend from current income is likely to be increased. This desire to spend is further accentuated by the fact that the assets are income yielding. The total interest receipts increase pari passu with the rise in the volume of assets which partake the nature of rent, being independent of current effort.

Again, the existence of public debt provides persons with a highly liquid form of assets, one which can be converted into cash at any time with little danger of loss. Liquidity implies the shiftability of the assets at virtually no risk of capital loss (60). Accordingly, individuals are enabled to increase their spending more quickly than they could if they had equivalent wealth in other forms. These liquid assets also enable the banks to increase bank credit. The transfer of these liquid assets into the portfolios of the Central Bank creates the high-powered money, which makes possible a multiple expansion of the total quantity of bank deposits. But the existence of the debt, with its heavy interest burden, makes the government very reluctant to increase the rate of interest in order to restrict the size of the credit creation. That means the accumulation of a large volume of financial assets impairs the power of the monetary authority to control the quantity of money by (a) enabling the owners of the assets to share this power independently of the monetary authority and by (b) constraining the monetary authority to relinquish the use of the interest rate weapon on account of the intensified widespread repercussions of interest rate variation (61). So the asset effects of public debt gives rise to inflationary situations.

(61) Borkar, op. cit. p. 104.
But as we have already seen, some inflation is indispensable and also desirable in a developing economy. Taxation on the scale required to finance development may not be attainable. Moreover, between tax-financed and loan-financed expenditure, the latter can be pressed into service more expeditiously. The modification of tax laws, the assessment of taxes and the collection of revenues, all involve considerable delay. Borrowing is the quickest form of raising funds. A reasonable degree of loan financing expenditure would, therefore, fit our established institutional arrangements better than the more drastic programme of wholesale deficit financing.

Another important criticism against public debt is that a mounting public debt will increase the rate of interest and the tax burden to service interest charges. Unless there is a further increase in public debt, increase in tax will be so great that it will depress investment which is the dynamic element in creation of productive capacity in underdeveloped countries. It is said that the public debt may eventually become so large that a further increase in tax rates may decrease tax revenue by decreasing national income (62). That means increased public debt has dangerous consequences for the economy.

This argument is based, however, on an unrealistic assumption of static national income. If increase in public debt is associated with growing income, the size of public debt cannot be considered a burden. The greater the growth of income,

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the lower will be the tax rate to service the debt (63).

The actual experiences of the U.S.A., U.K., Canada and Australia show that even though there has been enormous increase in national debt during the past one and a half decades, the debt service as a percentage of national income and of tax revenue has shrunk considerably because of the accompanying rise in national income. This can be seen from the table given below.

**TABLE V-2**

Debt service as per cent of National Income & Tax Revenue.

<table>
<thead>
<tr>
<th>Countries</th>
<th>National Income</th>
<th>Public Debt</th>
<th>Debt Service as per cent of National Income</th>
<th>Tax Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.A. ($)</td>
<td>72532 343600</td>
<td>45890 272825</td>
<td>10.3 1.9 19.6 9.9</td>
<td></td>
</tr>
<tr>
<td>U.K. (£)</td>
<td>5012 16267</td>
<td>7269 27112</td>
<td>4.3 4.6* 24.3 14.8</td>
<td></td>
</tr>
<tr>
<td>Canada ($)</td>
<td>4289 23049</td>
<td>3710 19055</td>
<td>3.0 2.1 29.4 11.9</td>
<td></td>
</tr>
<tr>
<td>Australia (£)</td>
<td>877 4579</td>
<td>1215 3889</td>
<td>1.4 0.7 15.8 3.1</td>
<td></td>
</tr>
</tbody>
</table>

* The increase of 0.3 per cent over 1939 is due to comparatively less of increase in national income.


Domar has given a detailed calculation of the burden of the debt. According to his calculations, if the government expenditure is financed by public debt and due to this, national income rises by a constant percentage (say by 2 per cent a year), the tax burden as a percentage of national income will be 4.44 in the first year; it would rise slowly for 300 years or more and will eventually settle down at 5.71 per cent and stabilise there.
In case of India also, the debt service has not become burdensome. Debt servicing in India amounted to Rs.14.1 crores in 1938-39. After varying between Rs.36.5 crores and Rs.42.1 crores in the 8 years since 1948-49, it stood at Rs.38.2 crores in 1956-57. When this burden is measured in terms of income and debt service ratio, the picture is not discouraging. The debt service in India formed 0.7 per cent of national income in 1938-39 and declined to 0.34 per cent in 1956-57 even though the outstanding debt of the Government of India increased from Rs.1205 crores in 1938-39 to Rs.4234 crores in 1957-58 - an increase of 3.5 times. In contrast to this, the payment of interest on debt in the U.S.A. was 1.3 per cent of national income in 1939-40, 2.5 per cent in 1949-50 and 1.9 per cent in 1956-57. Although the absolute size of debt increased from 46 billion dollars in 1939-40 to 273 billion dollars in 1956-57 - nearly sixfold - the interest charges as percentage of national income increased hardly by 0.6 per cent. The debt burden in U.K., measured in terms of interest charges as a percentage of national income reveals similar characteristics.

In terms of tax rate (i.e. revenue utilised for servicing the debt expressed as a percentage of total tax receipts), only a small portion of the total tax revenue has been used up to service the debt in India as in the U.S.A., U.K., Canada and Australia. About 18.6 per cent of tax revenue of Rs.75.4 crores was used to service the debt in 1938-39. In 1956-57, the debt service formed 7.7 per cent of the total tax revenue of Rs.495 crores.

This shows that the burden of debt is not heavy as is generally imagined. The only danger of increase in public debt is that it may redistribute national income in favour of the rich.
The real burden of public debt does not in fact depend on its size; it depends upon the distribution of the ownership of it. If the public debt is held by a small group of people, necessitating a large transfer of money to them, it will aggravate income inequality in the country. The transfer effect of public debt is generally considered to have undesirable repurcussions on the distribution of income in the community.

Public expenditures financed by a continually rising public debt is essentially, therefore, a conservative programme.

It must be admitted that even though public debt in most of the countries has increased in recent years, it has not yet come to such a size as to intensify inequality of distribution. In case of India, for example, while the absolute size of debt has increased three and half times its pre-war size, the relative size has declined by nearly 50 per cent due to a more than proportionate increase in national income. The following table shows that India enjoys a favourable position as compared to U.S.A. and U.K.

**TABLE V - 3**

Debt as percent of National Income in India, U.S.A. & U.K.

<table>
<thead>
<tr>
<th>Year</th>
<th>India</th>
<th>U.S.A.</th>
<th>U.K.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>National Total per cent</td>
<td>National Total % of National Income to (3)</td>
<td>Total % of Income to (5)</td>
</tr>
<tr>
<td></td>
<td>(Rs. crores)</td>
<td>(Million dollars)</td>
<td>(£ million)</td>
</tr>
<tr>
<td>1939-40</td>
<td>1934</td>
<td>1204</td>
<td>62.2</td>
</tr>
<tr>
<td>1948-49</td>
<td>8650</td>
<td>2456</td>
<td>28.5</td>
</tr>
<tr>
<td>1956-57</td>
<td>11010</td>
<td>3676</td>
<td>33.3</td>
</tr>
</tbody>
</table>

Again, between public and private investment, public investment is likely to result in less concentration of income and wealth since the government is likely to pay a similar rate of return per rupee invested and obtain a large share of its revenue by means of progressive taxes. Public debt is, therefore, preferrable to private debt. From the point of view of transfer effects, small individual savings are better than large savings. Because in case of small savings, ownership of debt is diffused and the problem of inequality is minimised. Since in case of India, the small savings together with State Provident Fund accounted for Rs.1036 crores or 40 per cent of total interest bearing obligations in 1957, the problem of inequality is not so great.

So far, the response of the people to public debt programmes has been fairly satisfactory. In the first five year Plan, market borrowings accounted for Rs.205 crores i.e. 10 per cent of the total outlay and small savings and unfunded debt accounted for Rs.304 crores i.e. 16 per cent of the total outlay (64). In the second Plan, the target of borrowing from the public was fixed at Rs.1200 crores (Rs.700 crores as market loans and Rs.500 crores as small savings). The target in respect of market borrowing has been more than fulfilled. Over the Second Plan period, market borrowing amounted to Rs.780 crores (65). But in case of small savings, the actual collections came to Rs.400 crores, a shortfall of Rs.100 crores. There is the need to intensify effort for collection of small savings. The

(64) Review of the First Five Year Plan, p.35. In the 1st Plan, the total amount proposed to be raised by internal loans, small savings, etc. by the Central and State governments was Rs.520 crores. The shortfall was, therefore, negligible.

(65) Third Five Year Plan, op. cit. p.98.
potentialities of small savings are large and they will grow further as incomes increase. The movement has so far been confined to urban and semi-urban areas. If co-operative agencies are organised in rural areas to mobilise savings, the target of Rs. 600 crores fixed for the third Plan can easily be attained. There will be probably no difficulty in collecting the target of Rs. 800 crores by way of loans from the public (net) during the third five year Plan. The total contribution to savings can also be increased provided there were new channels of savings. New savings can be realised by (a) extension of social and economic security which may include Old Age Security Fund, Employees’ Insurance Fund and Crop Insurance Fund, (b) Sale of Government Annuities and Bonds, (c) Certificates in lieu of Dividends and (d) Gold and Silver Certificates. These measures are likely to add substantially to resources of the government for economic development. Particularly sale of gold bonds might be of much use in mobilising hoarded gold and using it for purchase of basic capital goods and raw materials from foreign countries. If voluntary methods are not successful in introducing these new savings, they may be made compulsory or semi-optional. If there is a choice between voluntary and compulsory savings, the former is to be preferred. But when the former is inadequate, the latter has to be resorted to.

Of particular interest in this context is the practice in the U.S.S.R. where most of the public debt is held by the citizens. Every worker is expected to purchase government bonds

(66) According to the estimate of Dr. Baljit Singh, such type of savings would contribute about Rs. 2100 crores within the Third Five Year Plan. See his 'Compulsory Savings' - Indian Economic Journal, April 1960 for a detailed analysis of these methods of savings for economic development.
equal to two to four weeks salary per year. Apparently, there is no legal compulsion but the sanctions behind this expectation are so strong that everyone purchases his quota of bonds. Deductions are made out of wages for these subscriptions to government bonds at the source and their sale forms a regular feature of the budget. Contribution from this source has been as regular and high as from direct taxes (67). Keynes also made a similar suggestion for deferred payment during the second world war period (68). In case of India, in view of the urgent need for resources, these channels of savings may be made compulsory in initial stages. Once they are made popular, there may not be any need for compulsion. When saving habits grow, voluntary method of raising resources through loans may serve the purpose.

However, of all the methods of raising resources, the most important one is collective compulsory saving through taxation. The importance of taxation as a method of resources mobilisation is recognised by all. Mr. Heller says: 'To break out of this (vicious) circle, apart from foreign aid, calls for vigorous taxation and government development programmes; on this point, expert opinion is nearing a consensus' (69). This consensus in favour of compulsory saving in the form of higher taxation is due to the fact that this is the most effective means of increasing the total volume of savings and

(67) Ibid, p.381.
(68) J.M.Keynes: How to Pay for the War, Harcourt, Brace & Co., N.Y., 1940.
investment in any economy where the propensity to consume is normally high. And probably the only really effective way to step up capital formation in a country where most people are poor and the need for enforcing sacrifices from as wide a part of the population as possible is very urgent. A detailed analysis of taxation as an instrument of fiscal policy is, therefore, called for.