Karnataka State Open University
Manasagangothri, Mysore- 570 006

ಕರ್ನಾಟಕ ರಾಜ್ಯ ಮುಕ್ತ ವಿಶ್ವವಿದ್ಯಾನಿಲಯ
ಮಾನಸಗಂಗೋತ್ರಿ, ಮೈಸೂರು ೫೭೦ ೦೦೬

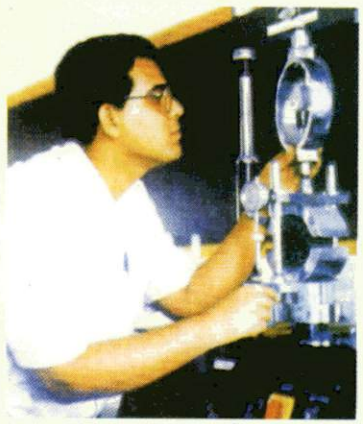
COURSE : 2

M.A. (PREVIOUS)
DEVELOPMENT ECONOMICS

435

Modern Agriculture

Industrial Development



Agriculture

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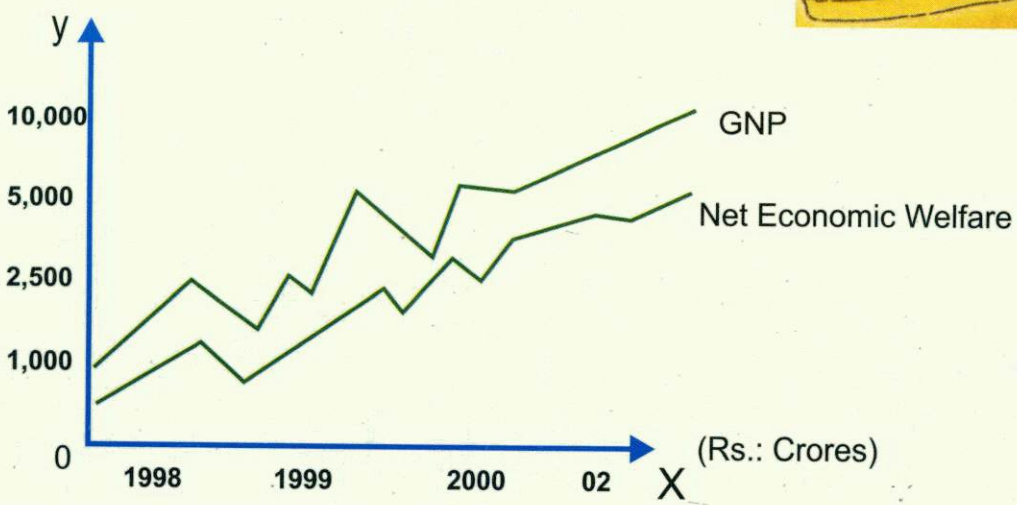

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Economics
Course 2

Block 7

Introduction

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COURSE 2 ECONOMICS OF DEVELOPMENT AND GROWTH

BLOCK 7 MACRO-ECONOMIC POLICIES

BLOCK INTRODUCTION:

The concept of Macro-Economic Policy refers to the whole range of monetary and fiscal policies, which the government employs to regulate the economic affairs of the country with a view to achieve certain pre-determined objectives. Macro Economic Policy deals with the problem of maintaining stability in different issues viz., price-level and balance of payments and such other issues which fluctuate as a result of recurrence of business cycles. Business fluctuations or cycles lead to both internal and external instability and affect resource allocation and income distribution. No doubt economic instability retards economic development. Therefore some policy for maintaining economic stability is needed. The policy that is designed to control business fluctuations and to maintain economic stability is the Macro-Economic Policy.

The main objectives of the Macro-Economic Policy are:

1) To maintain price stability
2) To attain balance of payments equilibrium
3) To achieve full-employment i.e. to use the resources efficiently to a maximum extent
4) To increase the pace of economic development / growth.

To attain these objectives and to increase the rate of economic development or growth, Macro-Policy Plays an important role. This policy is designed to reduce the lengths and severity of business fluctuations and to maintain economic stability on which development depends. To achieve its goals Macro Economic Policy implies two types of instruments: monetary policy and fiscal policy.

In this block:7, we shall discuss not only the objectives and role of monetary and fiscal policies, but also other aspects of development viz., domestic resources for economic development, deficit financing, inflation.

This block consists 4 units: unit 27 deals with study of monetary and fiscal policies, unit 28, explains domestic resources for economic development, unit 29, analyses how inflation affects development and unit 30 describes the role of deficit financing in Economic Development.

UNIT 27 MONETARY AND FISCAL POLICIES IN DEVELOPING ECONOMIES

STRUCTURE

27.0 Objectives

27.1 Introduction

27.2 Meaning of Monetary Policy

27.3 Objectives of Monetary Policy

27.4 Instruments of Monetary Policy

- 27.4.1 Bank Rate
- 27.4.2 Open-Market Operations
- 27.4.3 Variable-Reserve-Ratio
- 27.4.4 Selective Credit Control

27.5 Role of Monetary policy and Economic Development

27.6 Monetary Policy in Developing Economy

27.7 Effectiveness of Monetary Policy

27.8 Limitations of Monetary Policy

Check your progress - I

27.9 Meaning of fiscal Policy

27.10 Objectives of fiscal Policy in Developing Economy

27.11 Instruments of fiscal policy

27.12 Role of fiscal policy and Economic Development

27.13 Effectiveness of fiscal policy-

a) automatic fiscal stabilizer

b) Discretionary fiscal policy

27.14 Limitations of fiscal Policy

27.15 Interaction of Monetary and fiscal Policy

27.16 Let us sum up

27.17 Key words

27.18 Reference Books

Check your Progress : II

27.0 OBJECTIVES

After studying this unit, you will be able :

- To understand the meaning of the concepts Monetary and fiscal Policies
- To know the objectives of Monetary and fiscal Policies.
- To appreciate the role of both Monetary and Fiscal Policies in economic development of a developing economy.
- To analyse the effectiveness of both Monetary and fiscal Policies.

27.1 INTRODUCTION

Monetary and fiscal policies are two sets of tools of Macro-Economic Policy. With the help of monetary and fiscal instruments, Macro-Economic policy maintains internal price-stability by preventing the inflationary price rise and deflationary price fall. With the help of these two types of instruments Macro-Economic policy also maintains external stability by attaining Balance of payments equilibrium. Thus, by maintaining internal and external stability with the help of monetary and fiscal instruments, Macro-Economic Policy increases the rate of economic development. Hence it is also called "stabilization Policy". In this unit, let us discus the role of both Monetary and Fiscal policies in economic development of a developing economy in detail.

27.2 MONETARY POLICY

Meaning of Monetary Policy

Monetary Policy is a counter cyclical policy which seeks to expand money supply while the general economy is contracting and contract money supply while general economy is expanding.

According to monetarists, there is a relationship between money supply and economic activities. Change in money supply brings with it some change in price and there by affect economic activities like allocation of resources, distribution of income etc. Therefore, monetarists advocate for a counter cyclical policy which calls for adjustment in money supply to fit the needs of cycle-expand during recession and contract during inflation. According to monetarists, Monetary Policy, as an instrument implies those

measures designed by central bank for achieving certain objectives such as maintaining price stability, full employment etc.

27.3 OBJECTIVES OF MONETARY POLICY

The main objectives of monetary policy are:

a) To maintain Internal Price Stability
b) To attain equilibrium in the balance of payments and there by maintaining external stability i.e. maintaining stability in foreign exchange rates.
c) To maintain full-employment
d) To achieve rapid economic development / growth.

These are the four accepted objectives in both developed and underdeveloped countries. In developing economies, some additions are made to the list of objectives of monetary policy. They are:

1) To maintain continuously low structure of interest rates.
2) To assure the government that the deficits are financed at low interest rates.
3) To create a broad and continuous market for government securities.
4) To provide credit at differential interest rates to weaker sections and other preferred borrowers of the community.

Certain objectives of monetary policy are mutually reinforcing. The pursuit of one objective will contribute the attainment of the other. Eg: Control of inflation will assist in the achievement of equilibrium in balance of payments. On the other hand some objectives of monetary policy are conflicting in nature. Eg. Inflation cannot be reduced at the risk of temporary increase in unemployment. Therefore, the authority has to make a choice. In making the choice, priorities have to be decided keeping in view the economic situation and social circumstances of the economy.

27.4 INSTRUMENTS OF MONETARY POLICY:

In order to attain the objectives of monetary policy, the monetary authority-Central Bank employs

two types of instruments viz; General or quantitative measures and selective or qualitative measures. The quantitative instruments are:

27.4.1 Bank Rate:

Bank rate means Discount Rate. Bank rate is the rate at which the central bank discounts the bills of exchange. When bank rate is raised, money supply falls and prices come down to equilibrium level. When bank rate is lowered, money supply increases and prices rise and reach the equilibrium level.

27.4.2 Open-Market-Operations:

According to open market operations, when traders buy securities, bank reserves decrease, and lending capacity of banks also decreases and money supply and price fall. On the other hand, when the traders sell the securities, bank's reserves increase and bank's lending capacity also increases and money supply and price will increase.

27.4.3 Variable-Reserve-Ratio:

In the case of variable Reserve Ratio, reserves must be held against liabilities of banks with legal minimum, set by the revenue requirements. Raising or lowering the reserve ratio will affect the banks lending capacity and there by affect the supply of money and price level.

During inflation (i.e MS>DM) central bank employs general tools to reduce money supply and during deflation central bank employs these tools to increase money supply. These general instruments affect money supply directly.

27.4.4 Selective Credit Control:

Besides general tools, the central bank also employs qualitative measures, known as selective measures to control money supply and to attain the objectives of monetary policy. These selective instruments like credit rationing, moral-suasion, direction etc, affect the type of credit extended by the banks and there by the volume of money supply in the economy. The object of selective credit control is to control both the amount and terms on which credit is extended for selected purposes. Thus monetary policy employs general and selective instruments to attain its objectives like maintaining economic stability, increasing the rate of development etc.

27.5 ROLE OF MONETARY-POLICY IN ECONOMIC DEVELOPMENT / GROWTH

Monetary policy plays an important role in economic development / growth. It promotes economic development in different ways:

1) It maintains equilibrium between total money demand and productive capacity. This calls for a flexible monetary policy which aims at restricting bank credit, when total money leads to rise in prices and can set unsustainable boom. And it also aims at expanding credit when deficiency of total money demand causes decline in the prices, production and employment in the economy. Thus monetary policy helps to attain economic growth by maintaining price stability and ensuring full use of total productive resources.Monetary Policy, by eliminating cyclical fluctuations maintains price stability which reposes public confidence. It promotes business activity and ensures equitable distribution of wealth and income. As a consequence, there is a general wave of prosperity and welfare in the community.

2) Monetary Policy also plays vital role in economic development / Growth by creating favourable conditions for saving and investment. Maintenance of price stability encourages savings. When savings increases, investment will also increase. As a result, the rate of capital-formation will also increase and thereby increases the rate of development and growth.

3) Since monetary policy is flexible in nature, it acts directly on private investment, which is the most unstable sector of the economy. It affects output by changing aggregate demand which interacts with aggregate supply, to determine out-put and price.

4) Changes in money supply induces changes in interest rate. When money supply increases, interest-rate falls. Lower interest makes it profitable for firms to start new investment projects. This increases output, and thereby increases the rate of development. In the long run, prices and wages begin to adjust to the higher price and output levels.

5) Monetary policy also plays an important role in maintaining stability in foreign exchange rates. Exchange stability is helpful in promoting monetary co-operation and understanding among the various countries. Stable exchange rate plays key role in international trade. Monetary policy helps to regulate fluctuations in foreign exchange rate.

27.6 MONETARY POLICY IN A DEVELOPING ECONOMY

The role of monetary policy in attaining its objectives viz, price stability, full-employment etc, is restricted in developing economies. Because, the instruments of monetary policy are not conducive to the environments of developing economies where we find large existence of non-monetised sector, scarcity of financial institutions, immaturity of money and capital markets, disparities in income and employment, ignorance of the borrowers etc. Under these circumstances, the monetary authority i.e. central bank should take effective policy measures to step up the economy on sound footing. With this back ground, the monetary policy, in a developing economy, performs the following functions:

a) Adjustment between demand for and supply of money:-

Monetary Policy plays an important role in stimulating economic development of a developing economy by making an adjustment between demand for and supply of money. When economy develops, there is a continuous increase in demand for money. To meet this increased demand for money, monetary authorities increase money supply proportionately to avoid inflation. On the other hand, when price falls, demand for money also falls. Monetary authorities take proper measures to reduce the money supply to curb deflation. Monetary policy also helps to control speculative activities through direct control.

b) Price Stability:

Generally, developing economies face inflationary pressures due to structural rigidities and imbalances. Inflationary pressures affect the propensity to save and divert investible resources to unproductive channels. Sometimes, it leads to frequent devaluation of domestic currency and fluctuations in foreign exchange. All these hinder the economic development. Therefore, to remedy all these, monetary authority employs both general and selective methods to curb inflation. Thus, monetary policy helps in maintaining internal price stability and stability in foreign exchange rates and promotes economic development.

c) Credit Control:

Monetary policy maintains price stability through credit control. To control inflationary forces,

monetary authority i.e. central bank employs both quantitative and qualitative methods of credit control. But the success of credit control depends on the efficiency of financial institutions. But in developing economies, generally, financial institutions are not fully organized and developed. Therefore, quantitative methods like bank rate, open market operations, variable reserve ratio are not much successful in developing economies. Therefore, selective credit controls are more appropriate measures in controlling inflationary pressures in developing economies and increasing the rate of development.

d) Creation and Expansion of Financial Institutions:

In developing economies, monetary policy helps to improve their currency and credit systems. Monetary policy accelerates the economic development by improving the credit system. For this purpose, more banks and financial institutions should be set upto provide more credit facilities and to promote savings. Branches of these banks and financial institutions should be extended to rural areas. In this regard, net work of co-operatives is useful in providing rural credit. Besides, the central bank acts as fiscal agent of the government, guardian of money market and acts as a banker's bank and regulates the commercial bank. According Meier and Baldwin, "central bank control of commercial banks is the chief weapon of monetary policy".

e) Suitable Interest rate policy:

In developing economies, high interest rate is an obstacle to economic development. To encourage private investment and to induce economic development, low interest rate is essential. Low interest rate policy or cheap credit policy encourages not only private investment but also public investment. Cheap credit policy (low interest policy)attracts both domestic investors and foreign investors. Therefore cheap-money policy is an incentive to economic development. On the other hand, to avoid speculative borrowing and investment and restrict unproductive use of credit, monetary authority follows dear money policy i.e. charging high rate of interest, it restricts the unproductive and misuse of credit. Thus, monetary authority, by adopting suitable interest rate policy promotes economic development.

f) Debt-Management:

In developing economies, to implement development measures government borrows on large

scale. Therefore, monetary authority plays an active role in selling and buying securities and makes timely changes in the structure and composition of public debt. Thus, in developing economies, monetary policy has manifold aims to stimulate economic development, even though its role is secondary.

27.7 EFFECTIVENESS OF MONETARY POLICY

During the great Depression period, economists felt that the monetary policy was inefficient to stimulate recovery from Depression. However, since the fifties, monetary policy had gradually regained its importance and now it is employed for regulating cyclical fluctuations.

It is argued that monetary policy is more effective in recession than in inflation period. But however it still remains ineffective in severe depression. Because in the case of cheap money policy increase in demand for money (credit) depends upon interest elasticity of investment. Investment demand depends on marginal efficiency of capital. If prospect of making profit is bleak in the economy and highly uncertain, businessmen will not borrow. Keynes says during depression, if marginal efficiency of capital collapses, then there are no borrowers of funds even at low rate of interest. Besides, the rate of interest becomes sticky at the level of 2% and does not fall to zero. Even in the case of consumers, due to unemployment, if their income falls, their consumption expenditure also falls and demand for credit falls.

Monetary authority can follow tight money policy to achieve any desired reduction in aggregate demand through raising interest rate or credit rationing. Effectiveness of tight money policy is determined by government policy. There may be political limitations on how far tight money policy can be pushed because of the discretionary effects of credit restraints on certain groups of borrowers such as farmers, small businessmen etc. Besides, the effectiveness of tight money policy is also determined by increase in velocity of money, speculation and role of Non-Banking Intermediaries and absence of time lag.

27.8 LIMITATIONS OF MONETARY POLICY

The role of monetary policy in developing economies is restricted due to some limitations which are given below:

a) In developing economies, money market and capital markets are not fully organized and developed and this limits the success of monetary policy.

b) Existence of large non-monetised sector hinders the effectiveness of monetary policy. In rural areas, barter is usual practice, monetary policy does not function properly.

c) Loan markets like Bill market, Bond-markets are narrow and limited in developing countries.

d) The success of monetary policy depends on the consistency between monetary policy and government economic policies. In developing economies there may be contradictions between these two policies. Eg: on the one hand, government raises funds through deficit financing and on the other hand, monetary policy is stressed to take measures to control.

e) Another limitation is the existence of non-financial intermediaries which operate on large scale. These intermediaries in developing economies are beyond the control of monetary authority i.e. central bank.

f) In developing economies, lack of administrative honesty, problem of tax evasion, black-money, speculation, corruption, illegal trading-all these affect the efficiency of monetary policy.

g) The efficiency of monetary policy also depends upon the absence of time lag. No time should be lost between the need for and action taken. But in developing countries, monetary actions are subject to time lag.

h) Unproductive consumption expenditure and investment expenditure (investment on Jewellary)also affect the effectiveness of monetary policy and thereby retard the economic development of developing countries.

CHECK YOUR PROGRESS : I

1. What is monetary policy? What are its objectives.
2. Critically examine the role of monetary policy in economic development.

27.9 FISCAL POLICY

Meaning of Fiscal Policy:

Fiscal Policy is a package of economic measures of government regarding its public expenditure, public revenue and public debt. It is a major instrument of Government to attain certain major objectives

like maintaining economic stability, full-employment and economic growth / development. Popularity of fiscal policy has been largely due to the ineffectiveness of the monetary policy as a means of removing unemployment in the great depression of thirties. To day fiscal policy has become a major instrument of the Government to achieve certain objectives viz; full - employment, growth etc;

27.10 OBJECTIVES OF FISCAL - POLICY

The main objectives of fiscal policy are:

1. To maintain stability in the economy
2. To secure efficient allocation of economic resources.
3. To achieve full-employment
4. To accelerate economic growth

The goals of fiscal policy are likely to differ in different countries and in different situations. While in developed countries, the major goal is to maintain full-employment and thereby to stabilize the growth rate, in developing economies, main object of fiscal policy is to achieve development with stability, and to reduce inequalities. The following are the main objectives of fiscal policy in developing economies:-

a. To attain full –employment
b. To maintain price stability
c. To accelerate the rate of economic development
d. To attain optimum allocation of resources
e. To have equitable distribution of income and wealth and reduce inequalities.
f. To encourage saving and investment and to increase the rate of capital formation
g. To maintain economic stability
h. To provide employment opportunities

The objectives of fiscal policy are generally consistent. But sometimes, there might be conflict between them. Eg: there may be inconsistency between the objective of accelerating economic development and objective of counteracting with inflation, particularly in the initial stages of economic

development. When economic development proceeds, wealth gets concentrated in the hands of a few. If it is checked, it hinders the investment capacity, if it is unchecked, it leads to inequality in distribution. Therefore, it is not an easy task to determine the priorities of various objectives. Depending upon the socio-economic and political conditions the priorities of objectives differ from country to country and time to time.

27.11 INSTRUMENTS OF FISCAL POLICY

Fiscal policy is known as "Contra-Cyclical policy". To attain its objectives viz: full employment, growth etc, it employs its instruments which are described below;

a. Taxation

Taxation is the most powerful instrument of public authorities. Taxation brings the change in disposable income, consumption and investment. During depression, the objective of fiscal policy is to increase the purchasing power of the public by reducing the tax rate or imposing low rate of tax. Therefore, an anti-deflationary tax policy increases disposable income of the individuals, promotes consumption and investment. Effective demand increases and reduces the deflationary gap. During inflation, the objective of the fiscal policy is to reduce the purchasing power. An anti-inflationary tax policy reduces disposable income, investment and effective demand. To wipe off excess purchasing power, the fiscal authorities raise the rate of existing tax structure and also impose new taxes i.e. fiscal authorities may take measures to expand the existing tax base. Thus, anti-inflationary tax policy helps to plug inflationary gap.

b. Public Expenditure

Next to tax, public expenditure is effective instrument of fiscal policy. Government spends in order to increase economic development and to promote welfare of the public. Public expenditure affects the economic activities more directly than other fiscal instruments. During inflation, aggregate spending increases i.e both consumption expenditure and investment expenditure are high. Therefore during inflation, public expenditure (government's expenditure) aims at reducing the government spending by abandoning some schemes and postponing other schemes. During depression, government's public

expenditure policy aims at increasing the effective demand i.e increasing consumption and public Expenditure. During depression, deficiency of demand is the result of sluggish private consumption and investment. This deficiency can be met through the additional doses of public expenditure, equivalent to the deflationary gap. The multiplier and accelerator effect of public spending stimulate the path of recovery. Public expenditure helps to increase effective demand in two ways. (1) Government may expand its compensatory spending which implies certain types of relief expenditure viz, subsidy, social insurance payments, unemployment benefits, pensions etc. These are also called Transfer Payments which increase the purchasing power. (2) Government may resort to pump priming, which refers to increase in private investment through an injection of fresh purchasing power into income stream. Once the government spends money, the flow of economic activities would continue smoothly forever. According to pump-priming, public spending-a temporary additional expenditure will generate process to raise the level of employment and income.

c. Public works

According to keynes, public works -- programme is the most significant anti-depression device. It includes expenditure on public works, such as roads, schools, bridges, canals, airports, building, parks etc. Expenditures on public works absorb unemployed workers and increase their purchasing power and there by increase the effective demand. Public work programme provides incentives to industries, which are generally hit by the state of depression.

d. Budget

Budget is another effective fiscal instrument. This is also called "cyclical balanced budget". During inflation, governments holds surplus budget and curbs excessive spending activities. During deflation, government holds deficit budget to induce effective demand and there by consumption and investment. Thus, the cyclically balanced budget can stabilize economic activities. With the help of its budgetary policies, Government can easily adjust its finances according to the needs. This policy works smoothly in depression and inflation.

28.8 : KEY WORDS :

Domestic resources; low saving ratio; tax net; political will; private foreign capital; multinational corporations

28.9: CHECK YOUR PROGRESS:

(1) Discuss the role of taxation and public borrowing as methods of resource mobilization for economic development.

(2) Discuss the role of private foreign investment in resource mobilization for economic development.

(3) Discuss the different domestic resources for economic development.

28.10: BOOKS FOR REFERENCE:

(1) M.P. Todaro : Economic Development in the Third World, Longman, New York

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(4) R.N.Tripathy : Public Finance in under developed countries, sterling publications private Lt.

UNIT 29 INFLATION AND DEVELOPMENT

STRUCTURE :

29.1 Objectives

29.2 Introduction

29.3 The concept of inflation

29.4 Inflationary finance and economic development

29.5 Different views on inflation

29.5.1 Monetarists' view

29.5.2 The structuralists view

29.6 Criticisms levelled against inflation

29.7 Let us Sum Up

29.8 Key words

29.9 Check your progress

29.10 Books for reference

29.1 OBJECTIVE

This unit introduces you to the concept and the role inflation in economic development. After reading this unit you will be able to explain :

- the concept of inflation
- the role of inflation in economic development
- different views with respect to the origin of inflation , and
- criticism levelled against inflation

29.2 INTRODUCTION

Resource mobilization for investment is an important factor in economic development. To achieve economic development, investment resources are mobilized through taxation, borrowing, foreign-aid, deficit, financing and so on. When the government is not able to get sufficient resources for investment from these sources a deliberate inflation has been suggested to achieve the desired rate of economic development. A mild dose of inflation has been recommended not only to developing economics, where the existing level of voluntary sarving is inadequate to bring about a higher rate real output but also to developed economies to achieve rapid economic growth.

29.3 THE CONCEPT OF INFLATION

The term 'inflation' refers to a sizable and a rapid increase in the general price level. Inflation is generally associated with rapidly rising prices which causes a decline in the purchasing power of money. Prof. Crowther has defined inflation "as a state in which the value of money is falling i.e., prices are rising ". Prof. Hawtrey defines "inflation as the issue of too much currency". Prof. Kummever has defined inflation "as too much currency in relation to the physical volume of business being done" Thus according to these definitions the rise in the price level is caused by an increase in the supply of money.

The deliberate use of inflationary finance to promote economic development has been recommended by economists. Many under developed economies have for one reason or another resorted to this policy as a means to economic development. Inflation can be a growth promoting factor under carefully controlled conditions. The extra purchasing power resulting from inflation has to be used for capital formation rather than for public consumption of goods and services. When the capital created is productively used then the output in the economy increases.

It has been argued that inflation promotes economic development in two ways : (1) By redistributing the income from workers and peasants to capitalist entrepreneur. (2) It raises the nominal rate of interest, thus promotes investment in the economy.

30.4 INFLATIONARY FINANCE AND ECONOMIC DEVELOPMENT

Now let us see how inflationary finance helped economic development:

(1) It has been argued that inflation redistributes income and wealth in favour of the entrepreneurial classes who have high propensity to save or low propensity to consume. With the redistribution of income and wealth in favour of these classes, the rate of savings is automatically stepped up, leading to a higher level of capital accumulation in the economy. These clases utilize their increased savings for further investments in productive enterprises, thereby increasing the aggregate income, output and the volume.

(2) Inflation invariably creates optimistic conditions in the economy and afford fresh opportunities for businessmen and the entrepreneurs in new productive enterprises. Since the costs do not rise as rapidly as prices, the profit margin of the businessmen go up tempting them to make more and more investments in new industrial enterprises.

(3) There are generally large un-utilized and under utilized physical and human resources in under developed countries. They are not fully exploited because of shortage of financial resources. With the help of inflationary finance these resources can be fully utilized. With the help of inflation a country is able to invest more than what is saved and utilize its dormant physical resources. This will lead to more investment, more output and greater income and employment.

(4) Inflation provides adequate funds to the governments of an under developed country for launching upon development projects for quick economic development. There may be no harm in resorting to inflation for economic development because inflation is going to be self-terminating on account of the expansion of output.

(5) Under developed countries have got a large non-monetised sector in the rural areas which gets moniseted under the impact of planned development. With the monetisation of non-monetised sector in these countries the demand for money increases. Inflationary finance can help to meet this new demand for money.

(6) As living standards of the people rise due to planned development, their liquidity preference also increased, which means greater demand for money. Inflationary finance can help to meet this growing demand for money.

(7) In a developing country import surplus arise due to increasing foreign aid. More money is needed to handle this surplus inside the economy, Inflation helps in providing additional money supply to handle import supply.

Finally there is no doubt, that there will be some rise in prices at least in the initial stages consequent of inflation in a developing economy. The reason being that the supply of consumer goods in such an economy does not increase as rapidly as the supply of money in the initial stages. This is inevitable in the process of economic growth. Infact economic growth and inflation generally go together. Inflation leads to economic growth and economic growth in its turn, results in inflation.

e. Public Debt

Public debt is a sound fiscal instrument to curb inflation and deflation. Government borrows from banking institutions during depression. This causes a net addition to the circular flow and increases national income and employment. During inflation, government borrowing from this dry up almost completely. Since profit expectation is high in business during inflation, banks are loaded up and having no excess cash reserves. To fight against inflation, government may borrow from non-bank public and institutions by selling its bonds. So that consumption and investment capacity of the individual decrease.

Deficit financing is another method of public expenditure for mobilizing additional resources. When new money is printed, it results in net addition to circular flow. Thus, deficit financing is inflationary. Therefore, only during depression, deficit financing has desirable effect and helps to raise income and employment. Through this device, government gets additional resources at low cost and also creates appropriate monetary effects like low rate of interest, easy money supply etc. Thus, economic system registers a quick revival.

27.12 ROLE OF FISCAL POLICY AND ECONOMIC DEVELOPMENT

Fiscal policy with its instruments viz; tax, expenditure etc, accelerates the pace of economic development / growth. It checks cyclical fluctuations and maintains economic stability. It promotes consumption and investment to the level of optimum utilization of country's resources. Besides, by reducing tax rates, it increases the rate of savings and investment and thereby increases the rate of capital formation, which is an important ingredient of economic development. Through tax and public expenditure, government can reduce inequality in income and distribue and promote the welfare of the people. Thus, fiscal policy has tremendous advantages, as an important tool of macro-Economic policy. Through its powerful devices viz; public works, welfare payments, changes in tax rate, fiscal policy tries to achieve the goals of macro economic policies.

27.13 EFFECTIVENESS OF FISCAL POLICY

During inflation, increase in aggregate spending exceeds the rate of increase in the volume of

goods and services. To reduce the aggregate spending (i.e. effective demand), government creates surplus budget, increases the rate of tax. Surplus budget (Government's revenue > Government's expenditure) reduces aggregate spending. If total tax-revenue exceeds government's total expenditure then total spending will be less than what it would have been in the case of balanced budget. But, it the government uses this surplus to pay off its debt, then total spending may not be reduced. If the budget surplus is used to retire the outstanding government securities held by the central bank, the effect is the same as it is when the government impound surplus. Surplus budget may lead to primary reduction in aggregate spending. But since there is no net fall in money supply, secondary reduction which would be caused in spending from this source are eliminated. In recession aggregate spending is less than the volume of goods and services. To increase the aggregate demand government increases its spending by increasing public works by reducing tax rates, making welfare and unemployment payments, holding deficit budget. Deficit budget increases total spending and economic activities. The government tries to increase the expenditure by covering the deficit either by drawing on the reserves or by creating new money; or by borrowing from the central bank. But the problem that confronts the policy of deficit financing or deficit budget is the danger of inflation. Deficit budget increases the purchasing power and demand for goods. If the supply of basic goods cannot be expanded quickly, their prices raise and push up the cost of living. Deficit financing under full employment is inflationary. But during recession deficit financing is expansionary, since it increases employment and output.

a. Automatic Fiscal – Stabilizer

Fiscal policy acts as an automatic stabilizer. It has a built-in-stabilizer which functions automatically and removes delays in execution of fiscal policy. In depression, when gross national product tends to fall, as an automatic stabilizer fiscal policy increases investment and consumption expenditures. During inflation, fiscal policy automatically reduces investment and consumption expenditures.

Tax and expenditure are two important instruments of automatic fiscal policy. During inflation Government raises the tax rate to take away excess money from the business and households. Or Government reduces its expenditure on public works and there by reduces effective demand. During deflation, government reduces tax rate and thereby increases money with house holds and business. Or it increases expenditure on public works by undertaking projects like constructing dams, roads, canals, buildings and there by increases the employment opportunities and effective demand. Thus, fiscal policy acts as an automatic stabilizer.

b. Discretionary Fiscal Policy

Some fiscal devices viz; public works, income tax, welfare payments, unemployment benefit etc. are discretionary in nature. Public works include all activities that add to the stock of productive capital owned by the public. During full employment / inflationary period, government stops undertaking public construction works. On the other hand, during unemployment period (i.e. deflation) government undertakes many public work viz, construction like canals, roads etc.

During deflation, welfare payments can be made to the aged, families with young children in order to increase the demand. During inflation welfare payments can be stopped or reduced to reduce the demand.

During deflation, compensatory unemployment benefit can be paid to unemployees and during inflation, Government stops paying these unemployment benefits.

Progressive income tax is another discretionary fiscal device. During inflation government increases the rate of income tax on higher income groups, to reduce their consumption. On the other hand, during deflation, in order to increase the demand, saving and investment, government reduces the rate of income tax.

Thus some fiscal devices are discretionary in nature.

27.14 LIMITATIONS OF FISCAL POLICY

The main limitations of fiscal policy are:

1. Fiscal objectives are conflicting with the objectives of price stability and full employment.
2. It is difficult to determine how large should be the size of the budget to accommodate the changing economic conditions.
3. Due to political and administrative constraints, there is time lag between framing and implementing the fiscal policies.
4. High rate of tax may lead to tax evasion and generation of black money. It may also affect the saving and investment capacity of the people.

5. Public works cannot be started immediately. Since it is a long term programme, it requires proper planning. Therefore delay is natural. Public works are financed through borrowing during depression. Borrowing increases the burden of public debt.
6. Deficit financing is inflationary in nature.
7. The effectiveness of automatic compensatory device depends on elasticity of tax and flexibility of public expenditure.

27.15 INTERACTION OF MONETARY AND FISCAL POLICIES

Monetary and fiscal policies are complementary. The power of monetary policy is seriously diminished if it is not integrated with a sound fiscal policy. Eg. a tight monetary policy designed to cure inflation is incomplete with an expansionary fiscal policy running large budgetary deficits. During inflation, by combining the policy of surplus budgeting, with dear money policy economic stability can be achieved quickly and effectively. Similarly during deflation, it is possible to start quickly by combining policy of deficit budgeting with cheap money policy, Thus both fiscal and monetary policies are complementary and by co-ordinating both these instruments of macro-economic policy, economic stability can be achieved quickly.

27.16 LET US SUM UP

Both monetary and fiscal policies are two sets of instruments of macro-economic policy. But the policies aim at attaining economic stability, full employment and economic development / growth, and equilibrium in balance of payments. In a developing economies, other objectives are: to reduce inequalities, to secure efficient allocation of resources, to create broad market for government securities.

The main instruments of monetary policies are: Bank rate, open market operations and variable reserve ratio. With the help of these instruments monetary policy fights against inflation and deflation. Taxation and expenditure, public debt, budget are the tools of fiscal policy with which, it maintains economic stability , reduces inequality and increases the rate of development. Both monetary and fiscal policies have same limitations like time lag, political and administrative constraints, inconsistency etc: In spite of these limitations, both are effective measures of macro economic policy. Both are complementary.

Therefore by co-ordinating both monetary and fiscal policies, objectives of macro-economic policy viz. economic stability, rapid economic development / growth etc. can be attained quickly.

27.17 KEY WORDS

Monetary policy	-	Monetary policy is a policy which employs Central bank's control over supply of money.
Fiscal policy	-	Fiscal policy is the policy which includes government's expenditure, taxing, public debt, Budget.
Pump-priming	-	Pump priming refers to increase in private investment through an injection of fresh purchasing power into income stream.
Public works	-	Public works refer to government's public programmes viz; construction of roads, canals etc.

27.18 REFERENCE BOOKS

R.K.Lekhi	-	The Economics of Development and planning
M.L.Jhingam	-	The Economics of Development and planning

CHECK YOU PROGRESS : II

1. Discuss the objectives of fiscal policy in a developing economy.
2. Explain the various instruments of fiscal policy. What are their limitations?

Notes

UNIT 28 DOMESTIC RESOURCES FOR ECONOMIC DEVELOPMENT

Structure

28.0 Objectives

28.1 Introduction

28.2 The Role of taxation in resource moblisation and development

28.2.1 Personal income tax and property taxes

28.2.2 Corporate taxes

28.2.3 Indirect taxes on commodities

28.3 Public borrowing as a method of resource mobilisation

28.4 The role of private foreign investment in resource mobilisation and development

28.5 The benefits of private foreign investments

28.6 The defects of private foreign investments

28.7 Let us sum up

28.8 Key words

28.9 Check your progress

28.10 Books for reference

28.0: OBJECTIVES :

After reading this unit you will be able to analyse:

- The importance of domestic resource for economic development
- The role of taxation and borrowing in mobilizing resources
- Foreign direct investment and its implications on trade

28.1: INTRODUCTION:

In the absence of well organized and locally controlled money market, most developing countries, have had to rely primarily on fiscal measures to mobilize domestic resources. Here, the problem of mobilization of resources must be viewed not only in terms of financial resources but also in terms of real resources.

Among the various fiscal techniques of resource mobilization, taxation and inflationary financing constitute the compulsory mechanisms of forced public savings, whereas public borrowing is a voluntary technique for the mobilization of resources. In the context of the disproportionately low saving ratio and a large proportion of savings being diverted into unproductive channels in the under developed countries, taxation as a compulsory technique of resource mobilization tends to acquire a predominant importance. For the financing of a large investment plan of the public sector from domestic resources, main reliance has to be placed on taxation, because public borrowing of non- inflationary character may fail in the mobilization of an adequate volume of resources.

28.2: THE ROLE OF TAXATION IN RESOURCE MOBILISATION AND DEVELOPMENT

Traditionally, taxation in developing countries has had two purposes. First, tax concessions and similar fiscal incentives have been thought of as a means of stimulating private enterprise. The second purpose of taxation-the mobilisation of resources to finance public expenditures - is by far the more important. Whatever the prevailing political economic ideology of the less developed country, its economic and social progress largely depends on its govemment's ability to generate sufficient resources to finance an expanding programme of essential, non-revenue yielding public services such as health, education, transport, communications and other components of the economic and social infrastructure. As

an instrument of resource mobilization, its principal function lies in raising the volume of public savings to be used for capital formation consistent with the growth of savings in the economy as a whole.

Fiscal policy to raise the marginal prosperity to save above the average is concerned with the design and implementation of taxes to reduce private consumption (i) personal income tax and property taxes (ii) corporation tax and (iii) indirect taxes are of major importance from the point of view of their impact on economic development and their contribution to state revenue.

28.2.1: Personal income tax and property taxes:

It is observed that tax revenue as percentage of GNP is typically low in developing countries, averaging about 15%, compared to 30% in developed countries, and that taxes on income are a minor source of tax revenue compared with indirect taxes. The proportion of population that pays income tax in developing countries is correspondingly low i.e. around 5%. This figure compares with 60% to 80% of population of developed nations.

Inspite of this limited coverage and the fact that it is administratively too costly and economically regressive to attempt to collect substantial income taxes from the poor, it is nevertheless true that lower developed country governments have not been persistent enough in collecting taxes from the very wealthy. Since it is the highest income groups that offer the greatest potential yield to the tax collection, the large income inequalities prevailing in most third world countries mean that there is great scope for expanding income tax revenues. Moreover, where the ownership of property is highly concentrated and therefore represents the major determinant of unequal incomes property taxes can be an efficient and administratively simple mechanism both for generating public revenues and for converting gross inequalities in income distribution. But unfortunately it constitutes 10 percent of total revenue of poor countries. More over, in spite of much public rhetoric about reducing income inequalities, the share of property taxes as well as overall direct taxation has remained roughly the same for the majority of third world countries over the last three decades.

28.2.2: Corporate income taxes:

Taxes on corporate profits, of both domestically and foreign owned companies, amount to less than 2% of GDP in most developing countries, compared with more than 6% in most developed nations. The main reason why these taxes generate such limited revenue in third world countries is that there is

relatively less corporate activity in the overall economy, combined with a tendency of lower developed country governments to offer all sorts of tax incentives and concessions to manufacturing and commercial enterprises. And in the case of multinational foreign enterprise, the ability of lower developed country governments to collect substantial taxes is often frustrated.

28.2.3: Indirect taxes on commodities:

The largest single source of public revenue in developing countries is derived from the taxation of commodities in the form of import, export and excise duties. These indirect taxes which individuals and corporations pay indirectly through their purchase of commodities are relatively easy to assess and collect. This is especially true in the case of foreign traded commodities which must pass through a limited number of frontier ports and are usually handed by a few wholesalers. The case of collecting such taxes is one reason why countries with extensive foreign trade typically collect a greater proportion of public revenue in the form of import and export duties than those countries with limited external trade.

In selecting commodities to be taxed, whether in the form of duties on imports and exports or excise taxes on local commodities certain general economic and administrative principles need to be followed to minimize the cost of securing 'maximum' revenue.

First, the commodity should be imported or produced by a relatively small number of licensed firms so that evasion can be controlled.

Second, the price elasticity of demand for the commodity should be low so that total demand is not choked by the rise in consumer prices that results from the tax.

Third, the commodity should have a high income elasticity of demand, so that as income rise more tax revenue will be collected.

Fourth, for equity purpose it is best to tax those commodities like motor cars, refrigerators, imported fancy goods and household appliances, which are consumed largely by the upper income groups while foregoing taxation on items of mass consumption like basic goods, simple clothing and household utensils even though these may satisfy the first three criteria set forth above.

In a way, the ability of third world governments to expand their 'tax nets' to cover the higher income groups and minimize tax evasion by local and foreign individuals and corporations will largely

determine the efficiency of the tax system in achieving its dual function of generating sufficient public revenues to finance expanding development programmes and transferring income from upper to lower income groups in order to reduce poverty and income inequality. Much will depend on the 'political will' to enact and enforce such progressive tax systems.

However, no universal tax policy can be prescribed to suit all countries. The efficiency of different taxes to raise the level of domestic savings without offending equity and discouraging growth vary from country to country according to a host of social and economic circumstances. What seems vitally important, however, is that if a tax system is to be accepted by a poor community, it must be seen to be administered honestly and efficiently, which means that every attempt must be made to minimize the scope for evasion.

28.3: PUBLIC BORROWING AS A METHOD OF RESOURCE MOBILIZATION:

Public borrowing as a method of resource mobilization has certain advantages over taxation. Taxation, if pushed beyond a certain limit, has the danger of adversely affecting economic incentives, but public borrowing, even though it involves the withdrawas of resources by curtailing consumption just like taxes, does not produce any unfavourable reaction on incentives partly because of its voluntary nature and partly because of the expectation of repayment.

As against the orthodox theory of public finance, financing of public expenditure through loans in the context of a trade depression in an advanced economy is found to be highly advantageous even if it does not result in the creation of productive capital equipment. Thus in the Keynesian theory of public debt, the demand generating aspect of public debt is emphasized. If the developing economy sticks to the policy of loan finance, a growing public debt would not be a burden on the economy because with the growth of national income, such a debt tends to be self-liquidating.

In arguing against the accumulation of public debt, the classical theory had assumed the existence of full-employment, inelasticity of money supplies and unproductiveness of public expenditure for purpose other than defence, justice etc. But this view of public debt is not relevant in the context of an underdeveloped country. In such an economy public debt, if prudently and skillfully operated and managed, can become an important instrument of economic development. The public borrowing for financing productive investment generates additional productive capacity in the economy which would not

have been possible in its absence. To the extent that it is used as an instrument to mobilize savings which would otherwise have gone into hoards, investments in real estate and purchase of bullion, it becomes a positive instrument of economic development. A carefully planned policy of debt management while reducing the cost of the public debt may result in directing the flow of resources of the economy into the right channels. The classical assumption of a constant full-employment income does not fit into the model of a growing economy. The repayment of public debt out of an expanding national income does not have the dangers visualized by the classical theory.

28.4: THE ROLE OF PRIVATE FOREIGN INVESTMENT IN RESOURCE MOBILIZATION AND DEVELOPMENT

Experience of the developed countries show that external borrowing has played a significant role in their developing stage. England, the birthplace of modern industrialism borrowed from Holland in the 17th and 18th centuries and has provided capital for development of several countries in the 19th and 20th centuries. The USA also depended on external capital for its development, though afterwards it lent to several developing countries. Of Russia's national debt in 1914, about half of it was foreign capital. Experience of other developed countries is also similar. In recent decades, almost all the less developed countries are depending on foreign capital. The reasons for this are two viz, inadequacy of domestic savings and the necessity of importing machinery and tools and other capital goods not available at home.

Foreign capital takes two main forms, private capital and public capital. Private foreign capital may take the form of direct foreign investment or indirect foreign investment. Direct investment means that the concerns of the investing country exercise defacto control over the assets created in the capital importing country by that investment. Direct investment may take many forms like the formation of a subsidiary of a company in the investing country, formation of a concern in which the company has a majority holding, formation of a company financed exclusively by the concern in the investing country setting up a Corporation in the investing country for operating the other concerns, and creation of fixed assets in the other country by the nationals of the investing country. Those companies are called as the transnational corporations (TNCs) or multinational corporations (MNCs). Indirect investment known as "portfolio" or "rentier" investment consists most of the holding of transferable securities shares or debentures by the nationals of some other country. The share holders are entitled to dividends only.

At the turn of the 20th century private foreign capital mostly flowed in the forms of indirect investment from Europe to the developing countries. Direct investment flowing into the developing countries in the 1920s mostly went into the export sector and very little into manufacturing for the home market. Since II World War over half of the private investment has been directed and has been concentrated in the extractive industries. A small percentage has gone into the manufacturing and distribution. It is only when the economy 'takes off' that this investment goes into manufacturing.

Before the developing countries gained independence, private foreign capital was used as an instrument of exploitation. It resulted in an 'enclave' type of development. After the independence of these colonies the huge multinational corporations have expanded rapidly in the developing countries. The annual sales turnover of some of them is greater than the entire GNP of some of the developing countries, which means they would acquire economic and political power. These MNC's with their huge size can manipulate prices, profits and restrict competition.

28.5: THE BENEFITS OF PRIVATE FOREIGN INVESTMENTS:

Economists like Gerald M. Meier argue that foreign private investment confers the following benefits to the developing countries.

It goes directly into capital-formation, which pushes up the growth rate of the economy. This is used more productively, as profits are the main aim, when compared to public financial aid.

It stimulates domestic investment, as domestic ancillary units are set up to feed the main industrial units. Local enterprise may invest more in collaboration with foreign enterprise. In fact foreign enterprise encourages local enterprises in two ways -directly by fastening local enterprise with men, money and material and by importing training and experience to its personnel and indirectly by creating a demand for ancillary goods. They introduce new products, new tests and satisfy the specific needs of a particular country.

Direct private foreign investment helps to spread modern technology and efficient management methods. It transfers technology and helps the growth of skills.

Further it is linked to profits and is therefore more flexible when compared to foreign loans.

By bringing capital and foreign exchange, private foreign investment helps in filling the savings gap and the foreign exchange gap in order to achieve the goal of national economic development of these countries.

A part of the profits of this investment is generally ploughed back into expansion, modernization or development of related industries.

Private foreign investment adds more value added to output in the recipient country than the return on capital from foreign investment. In this sense the social returns are greater than the private returns on foreign investment.

Private foreign investment raises productivity and hence the real wages of local labour when industrialization due to private foreign investment takes place, the real wages of the newly employed workers are higher than the real wages of workers in the rural sector of the economy. If private foreign investment is in the export oriented industries it leads to a much higher social benefit than it is in import substitution industries. This is because the former have large background and forward linkage effects. If the export industries are labour intensive it means more employment.

The private foreign investment also influences the balance of payments position when the gestation period is long and profits are small in the earlier period, the strain on the balance of payments is very little. If private foreign investment goes into agriculture and extractive industries producing primary goods for export it helps easing the balance of payments position. In India it helps in producing manufactured articles, not only for the domestic market but also for foreign markets and thus helps the balance of payments position.

This flow of capital helps world welfare and the welfare of each country. It brings the countries closer together through international commerce by both vertical and horizontal economic integration and the transmission of tests, designs and technology.

It encourages the enterpreneneur of less developed country to invest in other LDC. For example, firms in India have started investing in Nepal, Uganda, Ethiopia, Kenya and others.

28.6 : THE DEFECTS OF PRIVATE FOREIGN INVESTMENTS :

Ragnar Nurkse and other economists have high lighted the defects of foreign private investment. According to them it has shifted competition thus reducing saving and investment rates and failed to reinvest the profit while inhabiting the growth of indigenous firms. Private foreign investment has not imported technical and managerial knowledge, which makes government regulation necessary.

The recipient countries may be required to provide basic facilities like land, power and other facilities, concessions in the form of tax holiday, development rebate, undistributed profits, subsidized inputs etc. Such facilities and concession involve cost in absorbing LDC's resources that could be utilized elsewhere.

The LDC's also provided facilities for transferring profits, dividends interest and principal. If these payments lead to a net capital out flow, they create balance of payments difficulties. Thus, the indirect costs of debt servicing and balance of payments adjustments create serious foreign exchange crisis adversely affecting the economy.

Besides, a large amount of money goes out of the country in the form of dividends, royalty and technical fees.

It may lead to distortion of the economic structure by damaging the host country in many ways. It may eliminate or at least suppress domestic entrepreneurship. Besides the use of oligopolistic practices, use of unsuitable technology catering to the affluent demand and thereby distorting the production structure. Paul Baran and Marxist economists argue that it leads to "exploitation" and "neo-imperialism".

Many foreign concerns operating in the LDC's reserve all senior executive posts for their nationals and pay them very high salaries with many perks which are a huge drain on the resources of the recipient country. At best they train local nationals for lower and middle level posts having little decision making. The lavish spending habits of these foreign national save an undesirable demonstration effect on the LDCs and create tensions.

The huge MNC's are able to influence the political climate of these countries. Besides the technology transferred is very often unsuitable to these countries, such that it harms the pattern of industrial development. Some of the MNC's interfere in the affairs of these backward countries and so their activities have been checked by the governments.

Another criticism is that the MNCs concentrate their research and development activities in the home country or in other industrialized countries. However the bulk of these costs are born by the developing countries. These payments after and above those remitted by way of royalties and technical fees. Further the MNC's generally enjoy a semi-monopolistic position and do not transfer their most advanced technology. A capital intensive technology is transferred which is generally unsuited to the labour surplus country. This aggravates the unemployment situation.

However, to encourage private foreign investment some economists have suggested the following measures: In the first place tax incentives can be employed to encourage private foreign investment. Discrimination between foreign and domestic investment must be removed or at least reduced. The risks of foreign investment must be insured against. The restrictions and regulations in the developing countries must be removed. As far as possible joint ventures should be set up. The infrastructure must be geared up to encourage the entry of private foreign investment. Above all there must be political stability in the country.

28.7: LET US SUM UP :

The problem of mobilization of resources must be viewed not only in terms of financial resources but also in terms of real resources. Among the various fiscal techniques of resource mobilization, taxation and inflationary financing constitute the compulsory mechanisms of forced public savings, whereas public borrowing is a voluntary technique for the mobilization of resources. Experience of the developed countries show that external borrowing has played a significant role in their developing stage. In recent decades almost all the less developed countries are depending on foreign capital. The reasons for this are two viz, inadequacy of domestic savings and necessity of importing machinery and tools and other capital goods not available at home. Before the developing countries gained independence, private foreign capital was used as an instrument of exploitation. After the independence of these countries the huge multinational corporations have expanded rapidly in the developing countries, which means there would be enormous economic and political power. These MNCs with their huge size can manipulate prices, profits and restricts competition. Economists like Gerald M. Meier argue that foreign private investment conferes the benefits to the developing countries. Raghnar Nurkse and other economists have highlighted the defects of private foreign investment. According to them it has shifted competition reducing saving and investment rates and failed to reinvest the profit while inhabiting the growth of indigenous firms.

29.5 DIFFERENT VIEWS ON INFLATION

There is an interesting debate among the economists with respect to the origin of inflation. According to monetarists, demand inflation is caused by an increase in the aggregate effective demand as a consequence of expansion of supply of money through credit creation. According to structuralists the inflation is caused by increase in production cost. In other words the monetarists emphasized demand pull inflation and structuralists emphasized the cost push inflation. The conttroversy runs as follows :

29.5.1 Monentarists' View

The monetarist school hold that the inflation has been the consequence of the expansion of spending financed by bank credit or credit creation, Businesses have been allowed to borrow on easy terms, Governments have been afraid to levy taxes or curb expenditure. Given the Business and government deficits stability could have been maintained by voluntary saving by households. However, households respond to the higher prices not by more savings but by less./ If the banking system were tightened up, or government would either reduce its spending or rise taxes or both the inflation would have been brought to a halt. In particular monetarists argue that the central banks should make it impossible for business or government to finance spending by credit creation, as opposed to real savings.

Monetarists believe that the social tensions and structural rigidifies are a result of extended monetary inflation and correction of inflation will lead to growth. They advocated restrictions on bank credit and on government borrowing from the banking system, especially from the central bank. They opposed price controls, over valuation and foreign exchange restrictions. Because controls will retrain investments, generate unemployment and loss in real output.

29.5.2 : The structuralists view

According to structuralists, the changes in spending and credit creation are not the root cause for inflation. Even if there were no increase in the total spending there would still be a possibility of inflation because of the in elasticity of the supply. Supply response is based not on monetary expectations, but on physical increases in an economy. As a result the demand for agricultural products increases. If the increase of food production is sluggish, food prices will rise, the inelasticity of agricultural production is largely due to defective pattern of land tenure which decreases the responsiveness of food production to increase in prices.

Similar shifts can take place in industry. Suppose that population grew faster than exports. This would mean that the average propensity to import consumption goods would have to decline and that domestic substitutes for import would have to be produced. If the supply of these were to be inelastic

price would rise and the currency would have to be devalued to prevent the balance of payments from turning adverse or import controls would have to be applied. In either case, rising import prices would increase costs, Industrialists, financed by bank credit would raise prices. The cost of living increases and wage earners would go on strike for higher wages. Farmers would respond to higher industrial price withholding supplies. A government deficit would follow, and the inelasticity of supply in import competing industry would lead to inflation.

Thus the structuralisms believe the monetary phenomena are the result and the rigidities, tensions and falling exports are the cause for inflation.

29.6 CRITICISMS LEVELLED AGAINST INFLATION

Group of economists headed by Prof. Milton Friedman believes distorts that inflation in no way promotes economic development of a country. According to them inflation dissolves saving habits of people, drive out the foreign capital, increases speculative activities and reduce volume of exports. It has been pointed out that the claim inflation helps in the transfer of resources to the investing classes has not been fully born out by facts. A study of inflation in the USA in 1939-52 shows that during these years labourers income rose by 6 percent contrary to the general notion that wages and salaries lag behind other income during inflation. Hence it has been pointed out that better and more equitable distribution of income and wealth is condusive of economic growth.

Even assuming that inflation results is the transfer of real income from wage earning to the profit earning class there is no guarantee that these resources will be profitably invested. Left to themselves, the businessmen in low income countries are likely to prefer investments whose ownership benefits are high such as foreign assets, gold holdings, accumulation of inventories, real estate investments etc, These things will not add to capital formation in the country. Apart from these there are certain obvious evils of inflation of a basic economic nature. Much of the increased earnings of the business classes and the profit earners are in the nature of wind falls and constitutes an eyesore to the wage earners and fixed income earners. On the absence of controls it is likely that savings will be expected by those who have lost confidence in the domestic currency. Again inflation reduces real rates of intervest and thereby affects the stability of the money rates and add to the uncertainties of calculation of the cost of any long term investment project.

Finally inflation creates an external imbalance also in the form of external payments deficits resulting from increased imports and fall is exports. There is besides the possibility, especially in undeveloped countries, of a mild or creeping inflation gathering momentum rapidly and developing into inflation of the run away type.

From the above discussion it is clear that there is need for a great deal of caution in the matter of inflationary methods of finding economic development. Therefore the safer methods and the one would be beneficial to the economy in the long run is to devise and adopt such techniques of financing that would bring about economic development with price stability. This is however, is difficult to attain in less developed countries and certain amount of increase in prices seems inevitable.

29.7 LET US SUM UP

Inflation is generally associated with rapidly rising prices which causes a decline in the purchasing power of money. The deliberate use of inflationary finance to promote economic development has been recommended by economists. Many under developed economies have for one reason or another resorted to this policy as a means to economic development. There is an interesting controversy between monetarists and structuralists with respect to the origin of inflation. According to monetarists, demand inflation is caused by an increase in the aggregate effective demand as a consequence of expansion of supply of money through credit creating. But according to structuralists inflation is caused by increase in production cost. According to a group of economists headed by Prof. Milton Freidman inflation distaorts saving habits of people, drives out foreign capital, increases speculative activities and reduces volume of exports. However it is clear that there is a need for a great deal of financing economic development.

29.8 KEY WORDS

Inflation, Inflationary finance; Monetarism'; Structuralism;

29.9 CHECK YOUR PROGRESS

(1) Define inflation, Discuss the concept of inflation in relation to economic development.

(2) Discuss the controversy between Monetarims and structuralism

(3) Critically evaluate the contribution of inflationary finance to economic development.

29.10 BOOKS FOR REFERENCE

(1) Leading Issues in Economic Development – G.M. meier
(2) Economic Growth – problems, policies – D.Bright singh
(3) Economic Development – Charles P.Kindleberger, Bruce Herric

UNIT 30 DEFICIT FINANCING AND ECONOMIC DEVELOPMENT

Structure :

30.1 Objectives

30.2 Introduction

30.3 The concept of deficit financing

30.4 The Role of deficit financing in Economic development

30.4.1 The Positive effect of deficit financing

30.4.2 The Adverse effect of deficit financing

30.5 Measures to control inflation resulting from deficit financing

30.5.1 Preventive measures

30.5.2 Remedial measurers

30.6 Deficit financing in India

30.7 Let us sum up

30.8 Key words

30.9 Check your progress

30.10 Books for reference

30.1 OBJECTIVE

This Unit introduces you to the concept, importance and the role of deficit financing in economic development. After reading this unit you will be able to explain :

- The concept of deficit financing,
- The role of deficit financing in economic development
- Measures to control inflation resulting from deficit financing and
- Deficit financing in India

30.2 INTRODUCTION

Deficit financing relates to the financial activities of the Sate. Even in economically advanced countries under the capitalist system, the states investment activities have considerably expanded in recent years. And such expansion has been justified and recommended by economists on the ground that ownership and operation of utility services by governments is necessary in the public interest, that large investment schemes like highways and hydro-electro projects have necessarily to be undertaken by governments and that in order to promote social welfare, move is to be spent by the state on public health and education and other welfare schemes. Further more, it is commonly accepted that in order to ensure an economic stability public investment on a large and increasing scale is necessary.

The need for large investment by the state has increasingly been realized in the under developed economies of today. Against the mounting investment expenditure, the normal financial resources of the state-receipts from government under-takings and taxation-have failed to respond satisfactorily. As a result, economic, development through the agency of the state, has strained the public budgets and caused budgetary deficits. It is not only in developing economies, but also is economically advanced countries the state's investment activities have considerably expanded in recent years. Therefore, when the state financial resources through taxation, public borrowing external assistance are not sufficient to meet these requirements, the government is forced to resort to deficit financing .

30.3 THE CONCEPT OF DEFICIT FINANCING

When the current resources of any administrative body fall short of its outlays there is a deficit in its budget. The term deficit financing denotes the measures adopted to cover this deficit and balance the expenditure against the receipts. Normally, deficit financing relates to financial activities of the state. Broadly speaking deficit financing is a technique that enables to government to incur expenditure beyond its current revenues. This becomes possible through the issue of additional currency. There is a considerable difference in the connotation of the term deficit financing between different countries, under

the following three situations : (1) When there are conditions of depression in advanced countries ; (2) When resources are required to finance a war; and (3) When the governments of developing countries require additional resources to finance their development Programmes.

In U.S.A. deficit finaning denotes the gap between the revenue receipt of the sate and aggregate budget expenditure including capital outlay and covers all the means of closing gap namely, use of cash balance, borrowing from the central bank and loans from the public. In India deficit financing refers to the short fall both in revenue and capital budget-the financing part of it refers to the use of cash balances and the short term borrowing of the government of the central bank and commercial banks. Thus while internal loans are considered as one of the means of covering the budgetary gap in the U.S.A. the proceeds of such loans are taken as part of the current receipts of the Government in India.

In advanced countries deficit finaning is resorted with a view to maintaining the level of effective demand and thereby ensure economic stability. The theoretical justification for this is based on the assumption that the major cause of depression is the fall in effective demand in the Keyesian se ıse of the term. Deficit financing in such a context would increase money supply and the purchasing pow'er of the people. But the efficiency of deficit financing as a means to promote recovery or maintain economic stability in advanced countries has been questioned. The large deficit spending encourages waste ful expenditure in the public sector and the consequent rise in cost and wages adversely affect in the private businessmen.

Deficit financing in under developed countries is resorted to in order to promote economic development. In recent times the need for large investment through deficit financing by the state has increasingly been realized in the under developed countries. This is because the state cannot hope to do much in mobilizing the available saving through the normal means of taxation and internal borrowing. But against the mounting investment expenditure, the normal financial resources of the states have failed to respond satisfactorily. For example the tax revenue in the in the under developed countries have remained below 10 per cent of the national product as against 25 to 40 per cent in economically advanced countries. As an economy grows, and the scale of expenditure of the states rises, the tax system should be resistant enough to provide adequate financial means to the government. But due to the laxity and inefficiency of the tax administration, the states are not getting sufficient resources in the under developed countries. As a consequence, the Government is forced to resort to deficit financing.

30.4 THE ROLE OF DEFICIT FINANCING IN ECONOMIC DEVELOPMENT :

Deficit financing in developed countries is designed to raise the level of effective demand, level of employment and thereby compensate for the deficiency in the private investment activity in time of depression. But in under developed countries it is designed to help in the increased mobilization of

savings and in the building up of real capital. There are statistical evidences to show that there is much idle resources in under developed countries. This is due to certain fundamental structural factors such as the non-availability of technically skilled Labour, lack of mobility of Labour etc., The need for deficit financing in these countries arises from the fact in that there is substantial difference between actual savings and potential savings. In view of large investment undertakings of the governments in these countries the need for much larger savings is obvious. But the means at the disposal of the government to mobilize at the potential savings of the community, are inadequate and unsatisfactary consequently the government is forced to resort to deficit financing, having many positive effect on economy. They are

30.4.1 The Positive effects of deficit financing:

(1) Deficit financing may be used for the development of economic and social overheads such as construction of roads, railways, power projects, schools, hospitals etc., By providing socially useful capital, deficit financing is able to breaks bottlenecks and structural rigidities and there by increases productivity.

(2) Deficit financing is an effective instrument of forced saving, when the government resorts to deficit financing, it takes away real resources from the people. The transfer of resources takes place in a concealed manner when the government buys goods and services for its own use. There being a shortage of real resources in under developed countries, little is left to be used by the people who are forced to save more. More over, deficit spending by the sate on development projects is made to increase employment, output and income. This leads to an increase in demand for consumer goods which lead to the rise in price due to deficiency in supplies. This process leads to inflation. In such situation a part of the increased income can be taken away through taxation by the government. It is another way of forced savings which can be utilized for capital for nation.

(3) Deficit financing helps in the mobilization of resources through rise in prices. In a period of rising prices the real income of fixed income earners and creditors declines, while that of the debtors and of people whose incomes are variable increases. Thus when prices rise, there is a transfer of income and wealth from fixed income earners and wage earners to the richer classes and the business community. Since the propensity to consume of the richer classes and business community is less than that of the fixed income earners and wages corners, such a transfer of income results in larger savings of the community and a possible rise in the level of investment.

(4) Deficit financing is always expansionary in its effect. As development gains momentum, the rate of investment in the economy is accelerated which requires additional doses of the quantity of money at every stage. When an economy begins to develop then total physical products increase, non-monetised sector is gradually transformed into monetised sector, with the rise in income, demand for cash balances increase and in the event of import surplus due to increasing foreign aid the demand for money increases. It is through deficit financing

that the government can meet the increasing demand for money in all these cases.

30.4.2 The adverse effects of deficit financing:

Deficit financing as a tool of economic development has its dangers. The damagers are inherent in its inflationary potential. When deficit financing merges into inflationary finance, it defeats its own purpose. A continuing rise in prices is a dangerous way of promoting economic development. Inflation is not only economically but also socially undesirable as a method of financing development. When the government invests the newly created money on capital projects, incomes of the peoples engaged in these projects and related services increase and with that propensity to consume is further intensified. But the various market imperfections and low elasticities of food supplies stand in the ways of increasing the supply of consumer goods in proportion to the expansion in money supply. All these factors tend to rise the prices of consumer goods and if they are not checked in time, they spread over the entire economy. The adverse effects of deficit financing is discussed as follows.

(1) Under developed countries are characterized by market imperfections. There is immobility of resources which leads to low elasticity of supplies. Such economies also lack large volume of fresh resources the demand for which is created by increased government spending. These factors create more shortages in supplies inrelation to a high demand there by leading to inflationary rise in prices.

(2) Deficit financing leads to increase in the income of the people. This results in the increase in the demand for food products. In under developed countries the elasticity of demand for food being as high as 0.8 the expenditure on food increases more than proportionately to the rise in the income of the people. Since the supply of food does not increase much due to low level of agricultural productivity, the prices of food articles rise and spread to entire economy.

(3) If deficit financing is used to finance quick yielding projects which tend to increase output within a short period or for producing consumer goods then it will not be inflationary as the supply of goods will increase to match the increased purchasing power in the hands of the people. On the contrary if it is used for financing long-term projects and for creating capital goods, it is bound to be inflationary. Lewis holds the view that inflation for the purpose of capital formation is in due course self destructive. Myint is of the opinion that inflation is not self-destroying in the face of acute shortage of consumer goods, and of the tendency by the marginal propensity to consume to be near unity in under developed economies.

(4) It is argued that inflation affects the habit of voluntary savings adversely. In the face of rising prices, it is not possible for the people to maintain the previous rate of savings. In addition to this, the real income of the fixed incomes, will be reduced and they will save less or they may not saves. Sometimes, a rise in prices may cause saving to be directed to profitable but unproductive forms of investment such as in real estates, gold jewellery

and so on. This type of investment is innmical to economic growth.

(5) A continuous rise in price caused by deficit financing brings about uncertainty in future expectations affects investment decision adversely. When prices rise, costs do not rise in the same proportion, thus there are higher profits. But in the face of continuously rise in prices strong trade unions press for wage increases, strike slow-down of work and general deterioration in Labour efficiency creates uncertainty in future business expectations and thus investment is adversely affected. Again a continuous rise in prices leads to rising costs and spiral inflation gets going in the country.

(6) Inflation as a method of forced savings has considerable social costs. Though the inflation helps to reduce consumption and increases savings yet from the social view point, it is a wasteful method of forced savings. The loss in real consumption of the masses tends to be greater than the gain in total savings of the community. Moreover as a result of inflation same sections of the community are made better off than others and it redistributes income in favour of entrepreneurial class at the cost of fixed incomes. This tends to increase disparities in income and wealth which may not lead to increased savings and investment.

(7) Further deficit financing increases the cost of development projects on the part of government with the rise in price level. If not checked in the earlier stages, the rise in prices becomes cumulative.

(8) Finally inflation leads to balance of payment difficulties. Since the marginal propensity to import is high in under developed countries, rise in domestic income an prices may encourage people to import more commodities form abroad. Increased imports cannot be matched by increased exports due to lack of diversification in the economy. Efforts to restrict imports lead to further rise in prices by bringing excessive pressure on domestic supplies.

30.5 MEASURES TO CONTROL INFLATION RESULTING FROM DEFICIT FINANCING :

Inflation resulting from deficit financing can be controlled by two ways. They are 1. Preventive measures 2. Remedial measures.

30.5.1 Preventive measures :

As far as preventive measures are concerned, the first is the principle of limiting deficit financing to the size of foreign exchange available to the country. It is based on the fact that external balances represent past savings so that any excess of investment over current domestic savings reflected in the budgetary deficit could be offset by making use of foreign balances. Deficit financing increases the purchasing power, and this process on the available supply of wage or consumption goods. This leads to rise in prices if not immediate increase in the domestic production. In such situation foreign resources

can be drawn upon or external borrowing may be resorted to, inorder to finance the import of consumption goods. This would have an obvious restraining effect on the price trends in the country. However, if the deficit financing is utilized in those schemes of investments which yield quick returns and which facilitate production of wage goods or consumption goods, the threat of inflation can be considerably reduced.

30.5.2. : Remedial measures :

They refer to the steps taken by the government when the symptoms of inflation have appeared. Inflationary upturns in prices is due to the excess demand in relation to supply. A well thought out tax policy can be successful in reducing the pressure of demand as well as in augmenting supply. Tax incentives in the form of tax exemption with a view to encourage savings or to encourage investment in particular lines of enterprises will help in containing inflationary pressure in the economy through their influence on supply side. The excess demand can be reduced first by absorbing the increased purchasing power by means of taxation and internal borrowing.

Secondly, with the increase in the purchasing power with the people there is a shortage in the supply of final goods and other resources in relation to demand,. If steps are taken to regulate the distribution of available supply by means of rationing, price control, control of distribution, then the inflationary pressure can be kept within limit. But it is very difficult to have an efficient system of controls in under developed countries due to lack of a good administrative machinery.

Thirdly, through control of capital issues and investment, financial resources can be made to flow into desirable channels or at least prevented from getting dissipated in unprofitable lines of investments. A suitable monetary policy involving control of credit and money supply particularly of the selective credit control type can succeed in directing investment into worthwhile undertakings and prevent flow of funds into undesirable channels of production.

30.6 : DEFICIT FINANCING IN INDIA

Deficit financing in India has been mainly adopted to enable the government to obtain necessary resources for five year plans. The level of outlay laid down are of an order which cannot be met only by taxation, internal borrowing and external assistance. Hence gap in the resources is made up through deficit financing.

The deficit is financed in India in one or more ways : (1) Borrowing from the Reserve Bank of India (2) Withdrawal of cash balances by the government (3) Borrowing from the commercial banks and 4) Issue of new currency by the government. Most commonly the government draws on its cash balances with the Reserve Bank and partly issues treasury bills which are purchased by the Reserve

Bank or the commercial banks. It means deficit financing is not going to create resources but it is only a device which helps in the transfer of resources to the government.

The extent of deficit financing in India has been increasing throughout the plan period. It was of the order of Rs.333 Crores in the first plan, Rs.948 crores in the second plan, Rs.1334 crores in the Third plan, Rs.1006 crores in the Annual plans, Rs.2960 crores in the fourth plan, Rs.5696 crores in the fifth plan Rs.16,570 corres in the sixth plan.

This shows that the government of India has not been able to find out adequate resources from taxation, income from government enterprises, small savings, proceeds of loans and various types of other receipts. Since sufficient investment is not coming from the private sector, government has to take the responsilibility of initiating process of economic development by undertaking a considerable amount of investment. And since the expenditure required for a speedy Programme of investment is very large, it would be very difficult for the government to raise the required resources through the usual sources of taxation. Hence deficit financing is resorted by the government for implementing various development schemes.

30.7 LET US SUM UP

The need for large investments by the state has increasingly been realized by the economists of today. But when the state's financial resources through taxation, public borrowing, external assistance are not sufficient to meet the mounting investment expenditure, the government is forced to resort to deficit financing. In advanced countries deficit finance is resorted with a view to maintaining the level of effective demand and there by to ensure economic stability, on the other hand deficit financing is under developed countries is resorted to in order to promote economic development. However, deficit financing with positive and also adverse effects on the economy play a predominant role in the economies of today. Inflation resulting from deficit financing can be controlled by preventive and remedial measures. Hence deficit financing is resorted to by both developed and developing countries of the world.

30.8 KEY WORDS

Mounting investment expenditure; to maintain economic stability; forced saving, market imperfections; quick yielding project;

30.9 CHECK YOUR PROGRESS

1. Define the concept of deficit financing and evaluate its growing importance.
2. Critically examine the role of deficit financing in economic development.
3. Discuss positive and adverse effects of deficit financing on an economy.

30.10 BOOKS FOR REFERENCE

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Charles P. Kindleberger : Economic Development

Jhingan : Economics of Development

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ಆದೇಶ ಸಂಖ್ಯೆ : ಕರಾಮುವಿ/ಸಪಾವಿ/4/517/2006–07 ದಿನಾಂಕ : 01/09/2006
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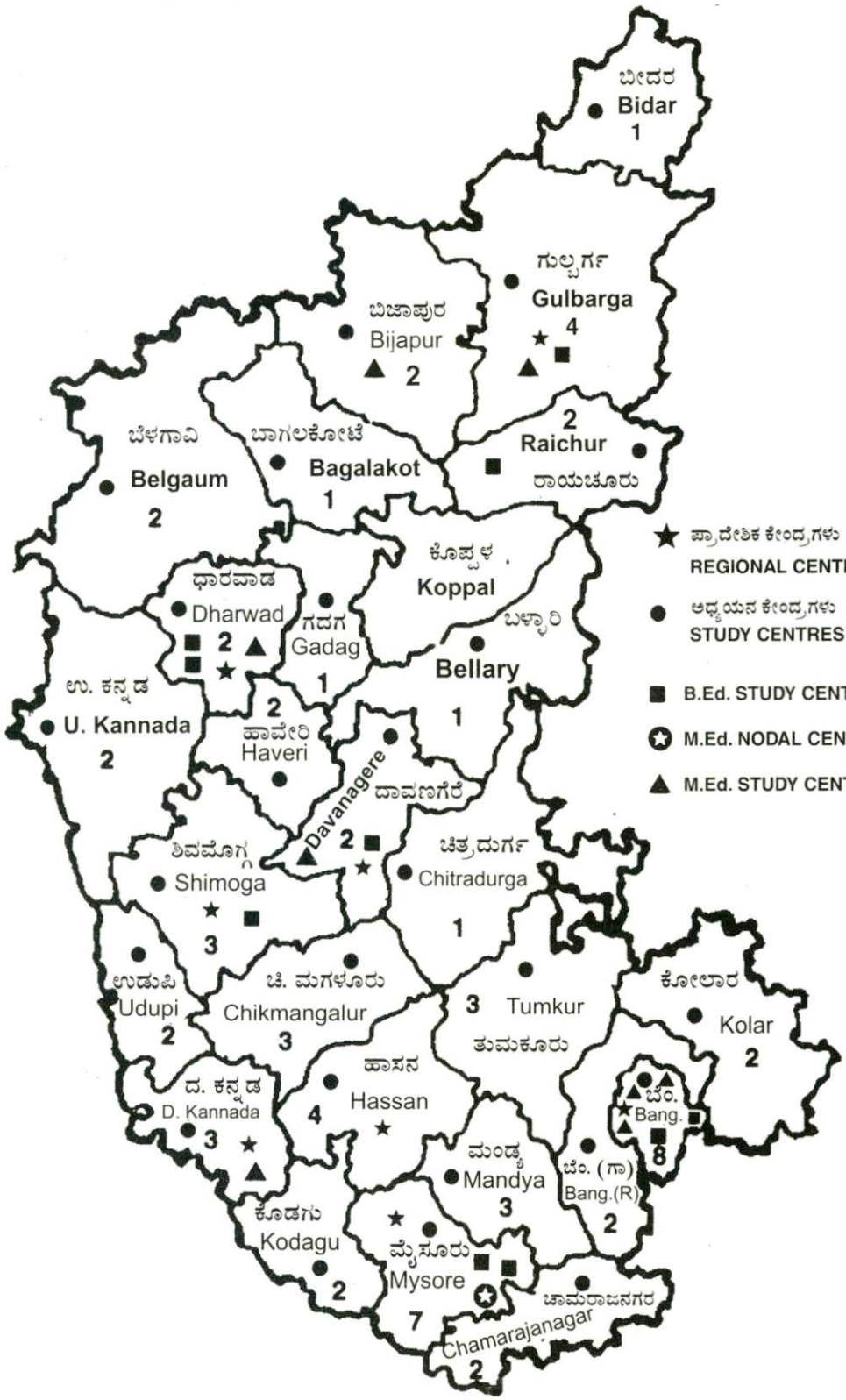

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