

FIFTEEN ANZA
CENTRAL BANKING COURSE
KARACHI
1964

FINANCING ECONOMIC DEVELOPMENT
DOMESTIC RESOURCES

FINANCING DEVELOPMENT IN THE PUBLIC SECTOR
AND PUBLIC ENTERPRISES

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The government sector is often called the "public" sector in discussions of the subject. The term "public", in this context, is not used in the sense in which it is used when one contrasts the "private" life of a person with his "public" life or in the sense in which it is used in the phrase a "public limited company". In the common controversy about, say, the merits of the "private" and "public" sectors, the term "public" is used as if it was synonymous with "government" or the "state". It may be more convenient to talk of the "government" sector, but that in common usage it is continuously referred to as the "public" sector must be borne in mind.

The word "sector" in the phrases government or public sector has also acquired a specialized meaning. The government sector does not comprehend all the activities of government. It is taken to refer only to economic activities of government and an important part of even economic activities is excluded. For example, the taxing and tax collecting activities of government are not ordinarily included. The term government sector derives significance from certain ideas or prejudices widely held in the West for some time regarding the proper sphere of activities of government. The narrow sphere of activities which laissez faire theorists defined as legitimate for the State are not included in the term "government sector". It is difficult to give precise meaning to a phrase so widely and loosely used. However, it would appear that government sector includes all economic activity of government relating to production, trade and transport and the finance of these. It also sometimes includes "social welfare" activities.

We are concerned not with the part played by government in economic development, which is a very large subject, but only with the role of the government sector in this context. During the twentieth century the extent of taxation and of government sector activity have steadily increased in all countries of the world. This has happened in countries outside the communist fold. The communist or the democratic socialist countries, which include a large part of the world, have economic systems which operate essentially under regulation of authorities of the State.

Some idea of the present taxation and government sector activity may be obtained from the following figures. In 1960 the share of government expenditures in the United States' gross national expenditure was 27 per cent. For the same year it was calculated that inclusive of all kinds of taxes,

social security contributions, etc., government in the Federal Republic of Germany took 42 per cent of the gross national product. (K. Brandt in *New Argument in Economics*. Ed. Schoeck and Wiggins, 1963., p. 25). Calculations regarding the importance of the public sector are much more difficult to get at. A recent attempt to measure the share of the investment in the public sector of total investment for the years 1950-57 yielded the following percentage figures for some important countries: United State 15, Belgium 23, Japan 35, France 36, Sweden 39, United Kingdom 48. The public sector in the above calculations comprised industrial, trading, transport and financial enterprises, public utilities and social services (Duggal: *Optimum Extent and Operation of Public Sector*).

This increase in the size of taxation and of public sector activity has been attributed to a number of factors. The dominant factor is obviously the industrial and technological revolution of the last two centuries. This has entirely changed, the conditions of transport of goods and men and the technique and organization of productive activity. The resulting large increase in the scale of and centralization in a number of key activities has led to great expansion in the activity of the state. Modern productive organization requires for its smooth operation a large number of services, many of which can be best rendered by an organization holding privileges which only a state can grant. The central banking and monetary systems are now universally set up by the state. Services like those rendered by the post, telegraph and telephone systems, railways, air and road transport, by electricity, gas and water supply agencies have to be granted franchises and privileges by authorities of the state both for establishment and for operation. The position of the purveyors of these services is usually so strong that public regulation of their activities is deemed necessary if they are run privately. In a number of the poorer countries the supply of these services is not expected to be adequate or economic unless the state takes the initiative in furnishing them. With rapid development of economies there arise problems of proper long-term conservation and of optimum utilisation of exhaustible natural resources, which also call for state regulation or direct state operation. With progress of economy of large-scale operations and other developments the number of entrepreneurs left in certain crucial fields become very small and dangers of monopolistic or quasi-monopolistic control of these areas arise which necessitate intervention by the state. Finally, with increasing emphasis on social security and greater equality the social security and welfare activities of the state have steadily enlarged.

This is the general position throughout the world. The events of the two world wars, and of the Great depression of the thirties have powerfully

influenced the course of events indicated above and have led to special developments in particular countries. The fear of unemployment and of spread of communism have accentuated the trends during the post-war period. An important new factor in the post-war period has been the urge towards deliberate reconstruction and development of national economies. This has been evident in all states, developed or underdeveloped, belligerent or non-belligerent. In most cases deliberate action has involved some sort of planning and considerable initiative and action by organs of the state. In the poorer underdeveloped countries the plea for planned development has received special attention; and this has inevitably thrust governments in the foreground. Because of the fact of underdevelopment governments in these countries have had to undertake provision of the fundamental socio-economic overheads on which development of all modern economic activity depends; they have had to undertake costly schemes for the development of natural resources such as for irrigation and power development; they have had to undertake establishment of crucial and basic enterprises either because nobody else was ready to launch them or because central control of their operations was deemed essential.

At the beginning of the fifties there was no general consensus of opinion regarding national planning or programming for development of underdeveloped countries. However, today an Economist with a high official position in the government of the United States is prepared to state as follows: "We believe national programming of the development process is required as a basis both for the domestic mobilisation of resources and effective foreign aid." (W.W. Rostow). The sentence also incidentally indicates the scope and purpose of national planning and programming. It makes clear that for proper planning a view has to be taken of the development process itself. This means looking into the future and chalking out the route which the economy is likely to take in the process of development or which it may be induced or directed to take. The core of the planning act is described by the phrase mobilisation resources. This has at least two facets; the first, that of taking stock of and gathering together all available resources, domestic and foreign; the second, that of the utilization directly of these resources, or their allocation for use. The route taken by the cumulative development process is implicated in the year by year utilisation and allocation plans. And the pace of the process is largely determined by the volume of resources that can be initially mobilised and the increases in them that can be made available in successive years. Acceptance of national planning and programming in the above sense involves acceptance of central decision-making regarding the raising of resources and also a minimal planning of their utilization and allocation. The specially wide taxing powers

of central governments in most states, the superior ability of central governments to borrow from the public and receipt by or through central governments of foreign aid from international organizations or foreign governments made the first inevitable. The ability to pool together resources to a very large extent makes it highly desirable, in a long-term development process, to attempt some central regulation of utilisation and allocation. These are the main tasks to be performed in formulating plans of development, whatever the agency entrusted with this responsibility.

While the finalisation of a development plan is almost everywhere a central responsibility the implementation of a plan and of its various parts cannot be highly centralised. The various agencies of plan implementation may be indicated by a twofold classification: Firstly by nature of authority, whether public *i.e.* governmental or private and secondly by area or coverage of operation such as country, state, local area, etc. In all organisationally developed structures — public, private or cooperative — in a large country, especially of the federal type, the area gradations will be fully in evidence. To the extent that the implementation of a scheme or programme is entrusted to an organ of government the attempted implementation is direct. This is in the sense that the task is allotted to an agency over which the planning authority itself has ultimate control. From this point of view all planned activity in the public sector is in the nature of direct utilisation of allotted funds. Of course, in a federal type of government the degree of control exercised by a central planning authority or government is not the same over state or local authorities as over organs of the central government. The difference is, however, one of degree and not of kind. Where plans of development require for their implementation action by private individuals or organizations these have to be led, induced or encouraged to act appropriately. Planners may thus have a preference for direct action by governmental authorities. However, in an underdeveloped economy economic activity is to a very large extent carried on by very numerous, dispersed, small-scale units and a plan of economic development necessarily involves influencing these and acting upon and through these. It was a characteristic of colonial regimes that even the most well-disposed amongst them undertook only such economic activities as could be properly centrally planned and executed. Large strategic railroad systems or big irrigation works were executed by these; the countryside, local development they perforce neglected. It is part of the essence of the post-independence plans of development of the ex-colonial countries that they not only undertake on a large scale and in a varied form the provision of the network of economic services and basic enterprises but have also to attempt to look after full development of dispersed, small scale private activity.

Activity in the government sector at all levels of area authorities arises out of the effort at implementation of plans. The national government and the governments of states and of local areas have all an appropriate share in the provision of socio-economic overheads and the conservation and development of natural resources. Certain large-scale key enterprises usually fall within the purview of the national government. However, where governments have to function as pioneers or pace makers in economic activity some direct conduct of enterprises by state or even lower area authorities becomes necessary. Important responsibilities devolve on state or provincial governments in the matter of rendering financial assistance, technical services, etc. to the cooperative sector and to the smaller enterprises. In this situation the mobilisation of resources used directly in the governmental sector runs up against problems involved in federal financial arrangements.

The mobilisation of resources for plans of development refers, in the main, to resources which are routed through agencies which governments control or of which they have direct cognizance. All plans of development underdeveloped countries include in their overall financial calculations resources which the planners guess and hope may be available but relating to the size and movement of which they have little direct information. Thus, all plans assume a certain amount of savings and investment by, say, farm households in their own business; in addition, the plans provide for financial assistance through government or cooperative agencies for farmer participation in plans of agricultural development. Some parts of agricultural development plans may be the responsibility of government sector agencies; others would require action by farmers in relation to their own business for which, in part, a public agency may provide funds. While the term mobilisation would usually cover only the funds of which government has direct cognizance and which it can to some extent control, the other part of the savings-investment process is also of importance. This is so specially because it is often found that government sponsorship of programmes and provision of funds in some contexts can lead to an increase in the savings-investment effort of the small household-enterprises.

It is, perhaps, a sign of underdevelopment that a large part of the savings in the economy are formed in households and are also to a substantial extent directly used in household businesses. In a developed economy, on the other hand, savings which are public *i.e.* governmental and corporate *i.e.* of incorporated business, predominate and the savings of private households are held chiefly as financial assets and are routed through financial intermediaries to ultimate investors. The transition from the former to the

latter situation is part of the process of development planning and of mobilisation of resources for the same. The effort at creation of a widespread network of commercial and cooperative banking and at creation of specialised financial agencies with such names as Industrial Finance, Industrial Development, Land Development, Small Business Finance, Industrial and Agricultural Refinance, etc. is aimed at transformation of the financial institutional situation and should make problems of mobilisation of resources progressively easier.

However, in the initial stages the new financial institutions serve more as means of directing resources for utilisation to appropriate quarters than as agencies for increasing or mopping up savings. For mobilising the savings of households, main reliance has then to be placed on taxation. The percentage of national income collected through taxation today by governments of underdeveloped countries is much smaller than that in the developed countries. Poverty and underdevelopment are both responsible for this. Development Planning requires that resources at the disposal of governments for investment and developmental expenditure be increased. The main means of achieving this is increased taxation. As development increases the national product and diversifies the economy, tax proceeds should rapidly increase. However, many difficulties are encountered in the transitional stage. These arise out of the number of objectives that tax policy has to aim at. It has to be the aim of tax policy to absorb increments in income in taxation. However, in doing this it must, on the one hand, not discourage production and savings effort and, on the other hand, affect adversely the low average standard of living of the people. It is sometimes claimed that fiscal policy should even aim at reducing the prevalent gross economic inequalities. Difficulties arise when an attempt is made to achieve all the aims simultaneously. A high proportion of tax revenue raised through a progressive personal income tax is generally considered to be an index of an equitable tax system. The share of such taxation in underdeveloped countries is at present small and has not been significantly increasing during the last decade. Attempts to increase this share usually come up against the arguments that very high rates of personal taxation act as disincentives to savings and against the general prevalence of widespread evasion. Taxation of company profits is directly related to the concept of the increase of corporate savings. If it is thought desirable to increase the contribution to savings made by the earnings of public limited companies ploughed back in own business by them a logical limit to the level of taxation of company profits emerges.

Today indirect taxation plays a much more important part in tax raising than direct taxation in most underdeveloped countries. It is generally

agreed that this predominance of indirect taxation makes, on the whole, for a regressive system of taxation. To avoid this general tendency it becomes necessary to choose particular measures of indirect taxation and to try and discriminate in the extent and objects of the incidence of such taxation. This is not an easy task in countries where the standards of consumption are relatively uniform and low. It is possible to a significant extent only where increased consumption of certain semi-luxury products can be identified as associated with increments in levels of income and taxation results in both restraints on consumption of these goods and restraints on the canalisation of extra resources in their increased production. Such selective taxation does not usually yield high revenues and resort is had to general measures like that of sales taxation. The major difficulties encountered by tax policy are thus the incompatibility of an equitable system of direct taxes with the objective of high level of savings of the rich or of corporations and the difficulty of restraining consumption only through tax measures without running the risk of iniquitous and undesirable consequences.

Certain public sector enterprises are in a position to obtain resources as a result of their own activities and need not depend, at all or entirely, on allocations from outside. Enterprises which have a surplus of receipts over expenditure may be in a position to effect net savings which they can utilise in business. Also some enterprises could borrow from the public on their own. The extent of the autonomy of the public enterprise and the type of its business activity are important in this context. Most public sector enterprises derive their capital resources from government, in the ultimate analysis. However, the arrangements under which this is done vary from case to case. Some may be administered almost as departments of government; in this case barring certain conventions regarding the keeping of accounts or the presenting of budgets there is little difference between these financial arrangements and those of other departments of government. Others may be independent statutory corporations or may be registered as companies — public or private. These may have initial resources placed at their disposal by government and may be allowed or expected to provide for themselves later or may be given limited or discretionary periodic assistance by government. The details of these arrangements are important chiefly in the context of exercise of parliamentary control or of concept regarding modes of guaranteeing efficiency of management. There is one subject which is, however, of wider economic significance and this relates to the pricing policy of public sector enterprises.

There are a large number of problems relating to price policy of public enterprises with which we are not directly concerned such as, for example,

the relative merits of average and marginal cost pricing or the extent to which discrimination in pricing should be practised. However, the issue of the overall level of prices charged as related to total profit-making capacity is directly connected with finance of public sector undertakings. A number of views can be and are taken relating to this issue. Subsidisation of particular customers or services even at the risk of increasing loss is advocated in certain cases; the no profit no loss formula is very popular though its precise definition raises many problems. It is often contended that public enterprises ought to aim at obtaining profits considered normal in the economy. And especially where discriminate quasimonopolistic pricing is possible there are many who urge that full advantage be taken of the situation to obtain extra revenues. It is obvious that the variations are related both to the type of enterprise under consideration as well as the socio-economic point of view of the protagonists. On the whole, there is considerable recent consensus that prices charged by public enterprises in underdeveloped countries tend to be low and that, where the results are not likely to be undesirable, a higher level should be maintained which provides for part of the resources needed for expansion.

Individual public enterprises may be in the position of meeting their own financial requirements through borrowing from the public by way of loans, debentures, etc. As a general rule, in the underdeveloped countries, few enterprises will be found which command sufficient credit by themselves and most of the borrowing of public enterprises, including financial enterprises, is backed by a government guarantee. Ordinarily the terms and conditions of the borrowing, its timing and its extent are also determined in consultation with the central bank and monetary authority. In the circumstances, what are the special advantages of some individual public enterprises borrowing directly from the public instead of all being financed through general loan raising by the central government? One possible advantage is that such loans can be offered at somewhat more attractive rates, etc. than the standard government loan without affecting the rate for the latter. It may be argued that this leads to a total larger effective supply of funds at a relatively low average rate. In a similar fashion it may be held possible for individual public enterprises to tap special sources of supply which may not be fully explored by general governmental borrowing. The second argument is not very convincing. For example, the Government of India, has, during the last decade, held in successive years opposite views relating to the matter. In some years, they have operated on the belief that the total result of the borrowing effort would be larger if the Government of the Union and the Governments of the States all entered the market. In other years the Government of the Union has considered it better to be

sole borrower and to meet the needs of the State from its borrowings. The relative merits of the two approaches depend also on the sources of supply of loan funds.

Who, in the main, support the government securities markets in the underdeveloped countries? Obviously, no generalised reply can be given to this question. However, certain features appear common. The savings of the average household are small and the attempt to convert them into holdings of financial assets has usually to be a highly specialised effort directed specifically to the particular situation of particular groups. Various types of schemes of cooperative, postal, small savings deposits and loans as well as insurance, provident fund etc. facilities have been elaborated in this context. The average household is thus not important in the market for government securities. The capital market in underdeveloped countries is, in most cases, highly limited in terms of extent of the investing public. Even where there is a capital market and a significant number of investors the relative attraction of private enterprise investment is too strong and private investors do not invest significantly in government securities. The government securities market, therefore, tends largely to be institutional. There are a number of institutions which for a variety of reasons including legal obligation, hold a part of their resources in government securities. Provident and other social security funds, Insurance companies, Commercial Banks, Private and Public Trusts, etc. are in this position. It is found that issues of government securities are largely taken up by these. In this context the chief merit of borrowing by individual public enterprise appears to be in part of the total borrowing being offered, in this way, at more attractive terms. There are usually no special classes of lenders that individual enterprises can particularly tag. This is brought out particularly in the Indian case because of the nationalisation of life insurance and of the Imperial Bank of India. Most issues of public enterprises, such as land development banks, housing finance corporations, electricity boards, etc. are dependent for success on substantial support by the Life Insurance Corporation, the State Bank of India, the Reserve Bank of India, etc.; and for obtaining this support, government intercession has often to be sought.

The total domestic resources that underdeveloped countries are able to raise, through taxation and borrowing, fall inevitably far short of their requirements particularly in the initial stages of development. Therefore, these countries have, during the last fifteen years, come increasingly to look to foreign aid to fill the gap. This applies with special force to non-communist countries which are not in a position to use the measures employed in communist countries for the mobilisation of physical, human and financial resources. Because the importance of helping underdeveloped countries to

develop has been recognised by developed countries, the sources and agencies making foreign aid available and the total volume of such aid have greatly expanded. The aid has been available through international organizations, through governments and through private investors. The extent of investment by private investors has, so far, been limited in intent and scope and does not play an important part in the finance of governmental enterprises. Most of foreign aid has been available in the form of loans. Grants have been confined largely to relief measures and to military aid. As the volume of foreign aid has grown, the proportion of loans has increased. Most loans, whether made by international or particular governmental organisation, are made on the basis of individual projects. The financial plan and the future working prospects of the project are examined, as in any long-term loan, by a bank before the loan is made. The International Bank which is the most important agency making such loans finances itself by raising funds in the international money market. The terms and conditions of the loans are, therefore, fairly heavy.

Government enterprises carrying out programmes of development which have a sound economic base are today in a relatively favourable position to obtain loan funds from abroad. Certain difficulties emerge when one looks at the entire government sector programme. The individual project approach necessarily leads to the lender looking not to a development plan as a whole, but only to those particular parts which may on examination be found to be good banking propositions. Moreover, the view that the bankers' experts may take of future prospects may, many times, differ from those of the internal planning authority. And, especially where the lender is connected with a particular government, the financial examination may be affected even by ideological considerations. In this manner, it is always uncertain whether any particular project will receive adequate foreign aid or not and the aid prospects for the plan as a whole over a series of years are even more uncertain. In many underdeveloped countries planning techniques have not been sufficiently developed and most underdeveloped countries find it yet necessary to undertake investments in relation to the "infra-structure" on which little or no direct return can be obtained. In recent years the need for assistance for such purposes has been recognised by the setting up of the SUNFED and the IDA. While the SUNFED makes grants for pre-investment projects, IDA gives only loans. These loans are also made only for projects which can stand scrutiny as banking propositions. They are, however, available on substantially easier terms. Another source of aid for projects which might not be good banking propositions is the surplus stock of commodities which some developed countries are ready to make available, under certain restrictions on very easy terms

An important aspect of foreign loans is the arrangement for their servicing and ultimate repayment. Many underdeveloped countries in, for example, Asia and Africa which had very small foreign debts ten years ago, are becoming heavily indebted today. Already some of them are finding that the servicing of foreign loans obtained by them on high rates of interest is taking up a substantial portion of their current foreign exchange earnings. As the foreign loans fall due for repayment the total burden on the economies will become progressively heavy. This imposes a limitation on foreign aid as a continuing source of development funds.

Foreign aid is, at present, found necessary not only for augmenting total resources but also for meeting the pressing need created by the development process for foreign exchange resources. Import of capital and of intermediate goods is a necessary concomitant of development planning in early stages and the normal trade transactions of underdeveloped are unable to earn the large foreign funds needed for this purpose. Ultimately normal investment and trade should suffice to meet total requirements. Currently, almost insuperable difficulties are encountered in an adequate expansion of the foreign trade of underdeveloped countries.

It is obvious that all underdeveloped countries planning economic development have continuously to face the problem of inadequacy of resources. The minimum rate at which it is thought desirable that the national product should grow, usually requires resources much larger than those available. Therefore, the plans are almost invariably overambitious and encounter in their implementation two sets of difficulties, physical and financial. The physical difficulties arise out of the extent of operations planned within the government sector. As long as the extent of these operations are limited government may hope to obtain most physical supplies that it requires by ordinary open market operations. However, when government's total requirements of, say, cement and rail transport or of technicians and imported machinery grow very large in relation to total supply some physical regulation and allocation become inevitable. Foreign exchange is almost everywhere scarce and planned investment with a significant import element leads to rationing imports both of capital and of consumer goods. Controlled distribution of rationed imports raises many difficulties but can hardly be avoided. Similar situations arise in relation to internal supplies of key commodities and services. This is not necessarily evidence of bad planning. A country which is poor in most resources must while attempting to develop rapidly plan such full utilisation of them that the fulfilment of the plan inevitably requires some extra-market devices for allocations of important and scarce materials and services, restraining

consumption of consumer goods, etc. The financial counterpart of this situation is that the economy is always on the edge of inflation and balance of payments problems.

A long term development plan requires a number of decisions regarding future investment projects and government activities which involve a period of gestation and some element of uncertainty. Firm financial commitments have, however, to be made in advance. The requirement of finding finances for increasing government activity and planned investment is compelling and non-postponable. An integrated plan of development must need be carried through as a whole if it is to yield full results. At the same time, the financial resources available *i.e.* proceeds of taxation, internal loans and foreign aid are liable to vary and the economy is subject to severe sudden strains as through an international recession or internal famines and floods. A full allowance for such risks and conservative estimation would inevitably make the size of the plan too low. Hence, the temptation or rather the requirement to put the size of the plan at the risky level.

What enables government to finance expenditures in anticipation of receipt of expected resources or to incur the expenditures even in face of an overall shortage of available resources? It is the power which governments have always used in times of stress, the power to create money. Whether through debasement of coins, the printing of notes or borrowing from the central bank against own securities, governments have been in a position to spend beyond the real resources commanded by them. In the context of the development plans of underdeveloped countries the process has, in recent years, been described as "deficit financing". Deficit financing is sometimes defined as the net increase in the government's indebtedness to the Central Bank, representing the excess of total public disbursements over public receipts from taxation, loans and other heads; it is also alternatively defined as the net borrowing of the government from the entire banking system. It is not necessary to discuss the relative merits of definitions as we are concerned chiefly with the possible consequences of deficit financing and the resulting limits on the process.

// It is widely agreed that under circumstances of a developing economy deficit financing may be permissible and safe upto a given extent. In certain circumstances such as that of regular increments in national product or increased monetisation of the economy anticipating creation of purchasing power may have no adverse effects. In specially favourable situations such as with a succession of good harvests the economy may not suffer or may even benefit from significant deficit financing. It is also argued that a measure

of inflationary pressure may help in removing some constraints in the way of development such as labour mobility and disguised unemployment. Deficit financing may thus find itself compensated. In such circumstances it is difficult to calculate in advance a 'safe' measure of deficit financing.

Deficit financing is dangerous if it leads to a significant degree of inflation or a large rise in prices. However, even post facto it is not easy on the basis of aggregative monetary and other data to establish clear casual relationship between deficit financing and movements of prices. In under-developed economies, the immobilities and discontinuities within markets and the importance of institutional and structural elements make it difficult to analyse factors responsible for causing variations in the course of a series of prices or in creating a cumulative effect. This does not minimise the real dangers if, in fact, deficit financing leads to heavy inflationary pressures. It, however, emphasizes the impropriety of making mechanical calculations in terms of an isolated structure of monetary and fiscal policy. Physical development plans and the physical measures taken to ensure their orderly implementation and fruition are inextricably connected with financial policy. Unexpected failure in financial provision has to be compensated for by a stricter regulatory policy as in times of war. Without such coordinated planning and its intelligent execution the real aim of all development planning *viz.*, the maximum continuous effort possible with the highly limited available resources cannot be contemplated or attained.

Printed at the State Bank of Pakistan Press, Karachi—1-64—100