61 PUBLIC EXPENDITURE

Of the two important aspects of Public Finance, *viz.*, Public Revenue and Public Expenditure, let us first study Public Expenditure. This department of public finance received scant attention at the hands of writers on public finance throughout the 19th century. Attention was almost exclusively focussed on public revenues. It is only in the present century that it came to be realised that public expenditure is far more important in its implications and bearing on public welfare than public revenue. The main reason for the early neglect of the subject of public expenditure seems to be that the amount of public expenditure was very small as the field of governmental activity was restricted. Now public expenditure has reached astronomical figures.

CAUSES OF INCREASE IN PUBLIC EXPENDITURE

In recent times, public expenditure has increased enormously. The main reason is that the functions of the state have increased manifold. In the past, the state was regarded only as a police state concerned with defence from foreign aggression and maintenance of law and order within the State. Now the State is regarded as a Welfare State which is concerned with promoting the welfare of its citizens. As such, it has to provide not only social security but it has also to look to economic stability and economic growth which calls for ever increasing investment expenditure.

The following are the principal causes of growing public expenditure:—

(i) **Increase in Area and Population.** In the first place, the increase in public expenditure is due to the fact that the physical boundaries of the States have been widened. 'No-man's lands' have been brought under organised government. Also, in cerin cases, even if the area has not increased, the population figures have considerably gone up Governments have, therefore, to cater to the needs of millions of more people scattered perhaps over a much wider area.

(ii) **Growth of State Functions.** As already pointed out, the modern States are no longer police states concerned mainly with the maintenance of law and order. They are now regarded as welfare states. This has resulted in a tremendous increase in their functions. While old functions are being performed more intensively such as administrative functions and functions relating to internal security and protection against aggression but numerous new functions are being undertaken, *e.g.*, optimum utilisation of national resources, economic growth, reduction of economic inequalities.

(iii) **Higher Price-Level and Rising Cost of Public Services.** Another reason which accounts for the mounting public expenditure is the higher price-level. Persons who have seen 'good old days' in India, or have heard about them, tell us that there was a time when ghee was selling at 4 annas a seer, whereas now it sells at twenty rupees per kg. There has been a similar rise in prices of other commodities. Governments, like individuals, therefore, have to find larger amounts of money to pay for the commodities and the services they have to purchase.

(iv) **Increase in National Wealth.** There has been almost a continuous improvement in agriculture, trade and industry in every country, though in some countries like India it has been painfully slow. There has been a steady increase in the per capita income and consequently an improvement in the standard of living. There has also been a corresponding improvement in public revenues and public expenditure.

(v) **Ability to Tax.** In a low-income economy, it is difficult to impose and collect taxes. But as economy develops, a much wider range of taxes becomes available to the State and as State revenue swells, public expenditure increases. Ability to tax raises the ability to spend.

(vi) **War and Prevention of War.** We know it to our cost now how costly a modern war is. England was spending £15 million daily during the last war. Even when the war is not on, large amounts are spent on preparing for it or on adopting means for its prevention. War has been one of the main factors responsible for increasing public expenditure.

(vii) **Provision of Public Utility Services.** Another important cause of increase in public expenditure is the provision of more and more public utility services, *e.g.*, water, electricity, transport services. It is now realised that some of the important wants of man can be satisfied more efficiently and economically if these are supplied collectively rather than each individual making his own arrangements. It is not considered desirable or economical that in a town there should be different companies supplying these services on a competitive basis. However, these public utility services are best provided by the State Government or local authority. Naturally, public expenditure goes up.

(viii) **Expansion in Social Services.** In modern times, there has been a remarkable expansion in social services like education, public health measures and medical aid. Expansion in educational facilities has led to the establishment of schools, colleges and technical institutions in very large numbers. The number of hospitals and medical colleges has multiplied manifold. Public health and sanitary measures are taken on a vast scale. There are also undertaken slum clearance programmes. Expenditure on these social services is also regarded as productive investment since it leads to increase in income and employment. Such expenditure builds up what is called human capital.

(ix) **As Musgraves observes, "Efficient product** mix between private and social good changes as per capita income rises, and this change involves a rising share of social goods."[1] In other words, when G.N.P. or per capita income rises it indicates the transformation of an economy from an agricultural or low income state to an industrial or high-income state. When this happens the output of social goods, *i.e.*, goods for the society as a whole, increases and public expenditure must inevitably go up.

(x) **Technological Changes.** Technological inventions call for larger or new production in the public sector, because it happens that improvements in techniques can be best exploited by the state. For instance, invention of internal combustion gave rise to a massive automobile industry necessitating the construction and improvement of highways. State expenditure naturally goes with the expansion of the public sector.

(xi) **Expansion of Public Sector.** Socialistic tendencies have in modern times resulted in the expansion of the public sector. As a consequence, public expenditure has gone very high.

(xii) **Defective Financial and Civil Administration.** Not a small increase in public expenditure is due to defective financial and civil administration. Duplication and unnecessary multiplication of governmental agencies is not uncommon. Wrong allocation of resources and functions also leads to extravagance. A lax control over public expenditure swells it to an unnecessarily high figure.

(xiii) **Political and Social Factors.** Political Development and changing social views have led to a great expansion of the public sector and increase in public expenditure. In a democratic State, there are several political parties and each party is anxious to enlist the support of the people. The supporters constantly clamour for concessions and benefits at the expense of public fund. From every corner of the country and from every section comes the call for more and more amenities. Ministers are asked by the people to open colleges in their home districts. Governments have thus been pressed by the democratic forces to take upon themselves more and more functions. According to Wagner's Law of Increasing State Activity, governments' functions have increased both intensively and extensively. The old functions are being performed more thoroughly and many new functions are being undertaken.

(xiv) **Welfare Activities and Growth of Transfer Expenditure.** All modern States wish to make liberal provision for social security schemes, or social insurance, *e.g.*, free medical aid, free education, old-age pensions, provident fund schemes, *etc.* These are known as transfers or transfer expenditure. These transfers were unimportant up to the thirties but they have phenomenally grown since then. All such transfers have substantially pushed up the State budgets.

(xv) **Requirements of Full Employment.** A modern State is anxious to underwrite full employment. To provide employment for all, the State must launch ambitious schemes of public works and public undertakings. Naturally, the public expenditure must shoot up.

(xvi) **Economic Development.** In all countries, whether developed or under-developed, the States have given top priority to economic development. The developed countries are desirous to raise their standard of living still higher, whereas the under-developed countries are anxious to attain a certain minimum standard. Economic development is a very costly affair. Lot of money has to be spent on economic and social overheads and many costly projects have to be undertaken. Measures have to be taken for the development of agriculture and industry, and so on. There is no wonder, therefore, that the size of the State budgets has become swollen everywhere.

Conclusion. Alfred Bûehler says in his **Public**

1. Musgrave, R.A., and Musgrave, P.B.—*Public Finance in Theory and Practice*, 1973, p. 126.

Finance: "To some persons a relative increase in public expenditure seems a calamity, to others it is a cause of rejoicing and to still others it is a matter of indifference. No definite percentage of national income can be named as the proper limit for the cost of government, since such a limit must depend upon relative circumstances. The proper size of the expenditure depends on the desires and needs of a community, the effects of government spending and the revenues supporting the spending, the willingness of the population to be taxed, existing burdens of taxation, the resources and population of a community, the distribution of wealth and incomes, the stage of economic development and other variables. The real issue is the advisability of a particular expenditure of a particular government at a particular time."

Revenue And Capital Expenditure

Public Expenditure has been classified into revenue and capital expenditure. Revenue Expenditure is current expenditure, *e.g.*, administrative and maintenance expenditure. This expenditure is of a recurring type while Capital Expenditure is of capital nature and is incurred once for all. It is non-recurring expenditure, *e.g.*, expenditure in building multipurpose projects or on setting up big factories like steel plants, money spent on land, machinery and equipment.

Developmental and Non-developmental Expenditure

Money spent on the maintenance of internal security, law and order, *i.e.*, on police, jails and judiciary and money spent on the army to provide defence against aggression is generally regarded as non-developmental, whereas the developmental expenditure includes expenditure on irrigation projects, rail and road transport, expenditure on agricultural and industrial development, and so on. Even expenditure on education and research is also regarded as developmental.

PRINCIPLES OF PUBLIC EXPENDITURE

Just as there are well-known canons of taxation, similarly it is possible to formulate some canons or principles to which prudent public expenditure should conform. These principles are:—

Principle of Maximum Social Benefit

It is necessary that all public expenditure should satisfy one fundamental test, *viz.*, that of Maximum Social Advantage. That is, the government should discover and maintain an optimum level of public expenditure by balancing social benefits and social costs. Every rupee spent by a government must have as its aim the promotion of the maximum welfare of the society as a whole. Care has to be taken that public funds are not utilised for the benefit of a particular group or a section of society. The aim is the general welfare. Government exists for the benefit of the governed and the justification of the government expenditure is, therefore, to be sought in the benefit of the community as a whole. (The principle of maximum social advantage has already been discussed in the previous chapter.)

Canon of Economy

Although the aim of public expenditure is to maximise the social benefit, yet it does not exonerate government from exercising utmost economy in its expenditure. Economy does not mean niggardliness. It only means that extravagance and waste of all types should be avoided. Public expenditure has great potentiality for public good but it may also prove injurious and wasteful. In the words of Coleridge, "The sun may draw up the moisture from the river, the morass, and the ocean to be given back in general showers to the garden, the pasture and the cornfield; but it may likewise force away the moisture from the fields of tillage, to drop it on the stagnant pool, the saturated swamp, or the unprofitable sand waste."[2] Thus, if revenue collected from the tax-payer is heedlessly spent, it would be obviously uneconomical.

To satisfy the canon of economy, it will be necessary to avoid all duplication of expenditure and overlapping of authorities. Further, public expenditure should not adversely affect saving. In case government activity damaged the individual's will or power to save, it would be repugnant to the canon of economy.

Canon of Sanction

Another important principle of public expenditure is that before it is actually incurred, it should be sanctioned by a competent authority. Unauthorised spending is bound to lead to extravagance and over-spending. It also means that the amount must be spent on the purpose for which it was sanctioned. Allied to the canon of sanction, there is another, *viz.*, auditing. Not only is previous sanction of public expenditure essential but a post-mortem examination is equally imperative. That is, all the public accounts at the end of the year should be properly audited to see that the amounts have not been mis-spent or misappropriated.

Canon of Elasticity

Another sane principle of public expenditure is that it should be fairly elastic. It should be possible for public authorities to vary the expenditure according to need or circumstances. A rigid level of expenditure may prove a source of trouble and embarrassment in bad times. Alteration in the

2. Macgregor—*Public Aspects of Finance*, 1939, p. 67.

upward direction is not difficult. It is easy, rather tempting, to increase the scale of expenditure. But elasticity is needed most in the downward direction. When the economy axe is applied, it is a very painful process. Retrenchment of a widespread character creates serious social discontent.

It is very necessary, therefore, that when the scale of public expenditure has to be increased, it should be increased gradually. A short spell of prosperity should not lead to long-term commitments. A fair degree of elasticity is essential if financial break-down is to be avoided at a time of shrinking revenue.

No Adverse Influence on Production or Distribution

It is also necessary to ensure that public expenditure should exercise a healthy influence both on production and distribution of wealth in the community. It should stimulate productive activity so that income and employment in the country increase, and it may be possible to raise the standard of living. But this object of raising of living standards of the masses will be served only if wealth is evenly distributed. If newly created wealth goes to enrich the already rich, the purpose is not served. Public expenditure should aim at reducing the inequalities of wealth distribution.

Principle of Surplus

It is considered a sound or orthodox principle of public expenditure that as far as possible public expenditure should be kept well within the revenue of the State so that a surplus is left at the end of the year. In other words, the government should avoid deficit budget. But the modern economists, especially Keynes, do not regard surplus budgeting as a virtue, rather deficit budgeting is more useful in raising the levels of income and employment in the under-developed countries. All the same, budget deficits running over a series of years are considered bad for the financial stability of the country.

Promotion of Economic Growth and Stability

In modern times, a very important principle of public expenditure is that it should promote economic development and economic stability, directly or indirectly. No public expenditure should impair the economy's potentialities for economic growth. In all public expenditure requirements of economic growth and economic stability (avoiding economic fluctuations) are kept in the fore front.

Conclusion

Public expenditure to be beneficial must conform, as far as possible, to the principles enumerated above. But the all pervading principle is that of **functional finance.** That is, public expenditure should be directed to the achievement of economic and social objectives in which the country may have set its heart.

EFFECTS OF PUBLIC EXPENDITURE

Effects on Production

There is a type of public expenditure which is regarded as unproductive. This refers to expenditure on the prosecution of, or the preparation for, a war. This belief, however, is not entirely correct. Military expenditure, if not overdone, does indirectly assist production by ensuring to the community an ordered economic life. Actually, it is overdone and a great deal of military expenditure may be regarded as unproductive. Also, we have to admit that a short and successful war may bring to the nation much economic gain by securing some economic privileges. In the same manner, by preventing an invasion of the country, the armed forces may enable the community to avoid an economic loss. Thus, military expenditure may be considered indirectly or broadly productive.

Most of the public expenditure is productive directly or indirectly. Governments, in every country, are running commercial enterprises which are directly productive. The Indian Government has created solid and lucrative assets in the form of canals and railways. The State enterprises make a direct contribution to production in the community. In the same manner, schemes of reclamation and afforestation are also directly productive. In all these ways, the level of employment in the country goes up.

A great deal of public expenditure is, however, only indirectly productive. In this connection we may consider the effects of public expenditure on—

(a) Power to work and save;
(b) will to work and save;
(c) diversion of resources as between employments and localities; and
(d) the total volume of employment and income.

As for **power to work and save,** it may be pointed out that much of the socially desirable public expenditure incurred by modern governments undoubtedly increases the community's productive power and, consequently, also the power to save. Such expenditure includes the provision of means of communication and transport, education, public health, scientific research and industrial research, controlling of human, animal and plant diseases, and expenditure on social insurance, like health insurance, unemployment insurance and old-age pensions.

As for **the will to work and save,** much depends on the character of public expenditure and the policy governing it. By giving the people expectation of future benefits from public expenditure, it may blunt the edge of the desire to work and save. The granting of old-age pension, insurance against sickness and unemployment and provision of education at State expense may make the people indifferent

towards the future and make them neglect saving. This is bound to affect adversely exertions in the present. People will work less. But if such expenditure is kept within proper limits and if it helps the really helpless, the check to work and saving may be negligible.

Regarding the **diversion of resources as between employments and localities,** the public expenditure may have distinctly a beneficial effect on production. Through the system of bounties and subsidies a government may succeed in diverting resources to hitherto neglected channels and thus create new industries. In the same manner, by spending money on the development of backward areas, the government may add to the total production in the country. A wisely conducted policy of public borrowing stimulates saving and the habit of investment in the community, which are certainly beneficial to production. It also diverts resources into channels which may add considerably to the wealth of the community.

We may thus safely conclude that wise public expenditure exerts a very wholesome influence on production. It assists production indirectly by adding to the power to work and save, and by a profitable diversion of resources. This is besides taking up directly the work of production through State enterprises.

Till recently, the discussion of the effects of public expenditure was mostly confined to the indirect effects discussed above. However, with the Keynesian revolution, it has come to be realised that public expenditure can exercise directly **an important influence on the level of economic activity, accelerate economic growth and help maintain economic stability.** We have seen previously that unemployment in the Keynesian system is due to deficiency of effective demand. Public expenditure has a direct influence on the level of effective demand. An increase in public expenditure during a depression helps to create more demand and thereby increases the level of output and employment. Indeed, at times, this direct effect may outweigh the indirect effects of public expenditure discussed above. (See also "Role of Public Finance in a Developing Economy" in the previous chapter.)

Conclusion. Thus, public expenditure increases production (a) by improving the productive efficiency of workers, (b) by providing economic and social overheads, (c) by giving direct assistance in the form of loans, grants and subsidies and technical advice and (d) by investment in public enterprises. Besides raising the level of production, public expenditure can influence the pattern of production or composition of output.

Effects on Distribution

Public expenditure can have a very wholesome influence on the distribution of wealth in the community. It can reduce inequalities of incomes. It is an admitted fact that the benefit to the poor from State activities is far greater than to the rich. A rich man can protect himself. He can make arrangements for the education and medical relief of himself and his family. But a poor man is helpless. It is, therefore, the poor man who benefits the most from the State activity. To this extent, the State expenditure seeks to bridge the gulf between the rich and the poor.

There is a certain expenditure which benefits the poor exclusively and primarily, *e.g.,* poor relief, old-age pensions and unemployment and sickness benefits. The benefits derived from such social services by the poor may be regarded as a net addition to their incomes. And when we remember that the revenue is obtained by taxing the rich, the conclusion is inescapable that inequalities of wealth distribution have been reduced to some extent.

But much depends, here again, on the character of public expenditure and the policy underlying it. Just as there are proportional, progressive and regressive taxes, in the same manner the government grants may also be proportional, progressive, and regressive. If public expenditure is really to make the distribution of wealth more even and fair, it must be progressive. It must be according to 'ability to receive' (corresponding to 'ability to pay' in taxation).

Corresponding to the principle of minimum sacrifice in taxation, there is the principle of maximum benefit in public expenditure. Public expenditure must be so arranged as to confer a maximum benefit on the community as a whole. This is the guiding principle. Judged in this light, we can see that expenditure on debt services is regressive, because it gives more income to the already rich. Granting of old-age pensions and benefits of social insurance are progressive. If a government subsidizes the production of commodities largely consumed by the poor, it is progressive otherwise regressive.

We have also to consider the reaction of public expenditure on individual income. If a government grant reduces the individual's desire to work and save, it may lead to reduction of incomes of the beneficiaries. In this case, the inequalities of wealth distribution are not reduced.

On the whole, public expenditure in modern times tends to make the distribution of wealth in the community more equitable.

Effects on Level of Income and Employment

We have discussed above the effects of public expenditure on production and distribution. We have also noticed that in modern times the sphere of state activity has very much widened. As a result public expenditure on several new items has increased manifold. This public expenditure affects

the level of income and employment in the country. Keynes has shown that the government can remove widespread unemployment during periods of depression through liberal public expenditure on public works. It can thus raise the level of income and employment in the country.

Keynes showed that when government increases its investment expenditure on public works, then the increase in level of income and employment in the country will not be merely equal to increase in income and employment in those activities, but it will be many times more than this through what he has called the Income Multiplier. The value of this multiplier will depend on the marginal propensity to consume in the country. For instance, if the marginal propensity to consume is 2/3, the multiplier will be 3 and if the marginal propensity to consume is $\frac{3}{4}$, the multiplier is 4, and so on. The value of the multiplier is found by the principle propounded by Keynes thus: Multiplier = $\frac{1}{1-mpc}$

If the value of the multiplier is 3, it would mean that if the government makes an additional investment of Rs. 100 crores on public works, then the national income and output in the country will not increase only by Rs. 100 crores but equal to Rs. 300 crores. In the same way, the volume of employment will not increase only as much as is provided by the public works launched by the government, but many times more. This happens because when government increases its investment expenditure, then at first employment increases in those works and the incomes of people employed in those works increase. Further, when these people spend their additional income on the purchase of consumers' goods, the demand for these goods increases and to meet this increased demand, their production will have to be increased. To increase production, some more people will be offered employment.

The effect of increase in public expenditure on the national income and employment is shown in the diagram (Fig. 61.1). In this diagram, national income is shown on the X-axis and consumption and investment demand on the Y-axis. OZ making a 45° angle with X-axis is the income line. As we have already read in the theory of income and employment, this 45° line is also called aggregate supply curve (Ch. 39). The equilibrium level of income is determined at a point where this line (*e.g.*, aggregate supply curve) cuts the aggregate demand (consumption and investment demand) curve and employment level will be determined corresponding to this income level.

In the diagram below, the aggregate demand curve C+I cuts the aggregate supply curve OZ at E according to which OY_1 national income is determined. Now if consumption and investment demand remains constant and government does not increase its expenditure, then OY will remain the national income and correspondingly the level of

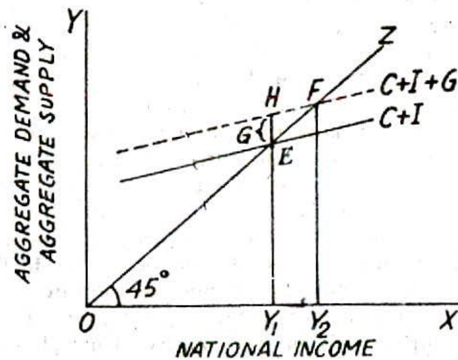

Fig. 61.1

employment. Rather, it is possible, and it happens during depression, that this level may go down owing to decrease in aggregate demand and there may be widespread unemployment in the country.

Now, according to Keynes, the government should increase its expenditure in such a situation so that the level of national income and employment in the country may increase. In the above diagram, if the government increases investment expenditure by EH, the aggregate demand curve moves upwards as shown by the curve C+I+G. Now this new aggregate demand curve C+I+G cuts the aggregate supply curve at F and accordingly the national income increases to OY_2. It will be seen that even though the government has increased its investment expenditure by EH, the national income has increased by Y_1Y_2 which is many times more than the increase in investment.

In this way, Keynes has shown that during depression the government can remove unemployment by increasing its public expenditure. Thus, public expenditure can vitally influence the level of national income and employment in the country and maintain economic stability by eliminating economic fluctuations.

Effect on Income and Employment in a Developing Economy

Above we have explained the effect of public expenditure on income and employment in developed countries, *viz.*, it is to ensure economic stability by eliminating economic fluctuations. The problem of developing economies is different. Here the low level of income and employment is due not so much to deficiency of demand, as in developed countries during depression, but to deficiency of capital stock. It is for the state to make up this deficiency through a wise policy relating to public expenditure. Public expenditure in developing economies is to be mainly directed to the acceleration of economic development.

The government in a developing economy can, with adequate and properly directed public expenditure, build up the requisites of economic growth, *viz.*, social and economic overheads or the required infrastructure, *e.g.*, sound educational base, adequate public health measures and medical aid to improve human capital in the form of physically strong and healthy and skilled labour. The government can also launch public enterprises and build up heavy and core industries of strategic importance. It can also promote agricultural development by making adequate provision for the supply of critical inputs in the form of irrigation facilities, fertilizers, improved seeds and pesticides. In these and many other ways, public expenditure can be used as an instrument for raising the level of income and employment in the country. Through public expenditure, government can raise the rate of capital formation in the country and thus promote economic development. It would provide employment and build up productive capacity of the economy.

In India, we see that the government is spending lot of money under the five-year plans on schemes of capital formation. It has spent crores of rupees on irrigation and power by undertaking multipurpose projects, on roads, railways, on huge steel plants, machine-making industry, heavy engineering and heavy electrical industry, fertilizer industry, and so on. This has substantially added to the volume of employment and productive capacity in the country. These are important steps towards removing unemployment and poverty in the country.

For creating employment directly, the government in India has started special employment schemes. Rural Public Works Programmes have been launched to provide employment for the people in the rural areas. These public works include irrigation schemes, road construction, flood control, soil conservation schemes, *etc.* It is proposed to increase substantially expenditure on these schemes during the Fifth Plan period. In this way, the government has created additional employment opportunities and added to people's incomes.

To create opportunities for self-employment in the rural areas, the government has started special schemes. Small Farmers Development Agencies (S.F.D.A.) have been set up which help the small farmers in getting improved seeds, fertilizers, pesticides, irrigation facilities, *etc.* They thus make their employment more productive and increase their incomes. Then there are Agencies for Marginal Farmers and Landless Labourers (MFAL) which impart them training in, and provide finance for, poultry, dairy, animal husbandry, *etc.* Thus, gainful employment is provided for such people and their earnings are increased.

Similarly, to remove unemployment among the educated people and to provide them opportunities for self-employment they are assisted through technical training and financial assistance, to start small-scale industries. Financial aid is given directly by the State and also through the nationalised banks and other financial institutions set up for the purpose.

Thus, the governments of under-developed countries like India, by increasing their expenditure on economic development and capital formation, can make valuable contribution towards increasing income and opportunities of employment in the country. Public expenditure in developing countries, therefore, plays a very vital role in raising the level of income and employment in the country.

ROLE OF PUBLIC EXPENDITURE IN A DEVELOPING ECONOMY

Under-developed nations are keen on rapid economic development which requires huge expenditure to be incurred in the various sectors of the economy. The private sector is either unable to find and invest these huge amounts or it is unwilling because the return from such investments may be uncertain or long delayed. Hence, economic development has to depend almost entirely on public expenditure. Public expenditure, therefore, plays a vital role in economic development of an under-developed economy.

Public expenditure promotes economic development in the following ways:

Social and Economic Overheads. Economic development is handicapped in under-developed countries on account of the lack of the necessary infrastructure. Economic overheads like the roads and railways, irrigation and power projects are essential for speeding-up economic development. Social overheads like hospitals, schools, and colleges and technical institutions too are essential. Money for these things cannot come out of private sources. Public expenditure has to build up the economic and social overheads.

Balanced Regional Growth. It is considered desirable to bring about a balanced regional growth. Special attention has to be paid to the development of backward areas and under-developed regions. This requires huge amounts for which reliance has to be placed on public expenditure.

Development of Agriculture and Industry. Economic development is regarded synonymous with industrial development but agricultural development provides the base and has to be given top priority. Government has to incur lot of expenditure in the agricultural sector, *e.g.*, on irrigation and power, seed farms, fertilizer factories, warehouses, *etc.*, and in the industrial sector by setting up public enterprises like the steel plants, heavy electricals, heavy engineering, machine-making factories, *etc.* All these enterprises are calculated to promote economic development.

Exploitation and Development of Mineral Resources. Minerals provide a base for further economic development. The government has to undertake schemes of exploration and development of essential minerals, *e.g.*, coal and oil. Public expenditure has to play its role here too.

Subsidies and Grants. The Central government gives grants to State governments and the State governments to local authorities to induce them to incur some desirable expenditure. Subsidies have also to be given to encourage the production of certain goods especially for export to earn much-needed foreign exchange.

Conclusion

Thus, public expenditure has to play a vital role in economic development. It is required to create and maintain conditions essential for economic growth. It must improve climate for investment and provide incentives for savings. The private entrepreneurs have to be assisted and inspired in every possible manner to venture forth and launch industrial and commercial undertakings. Public expenditure creates the necessary environment for the expansion of private enterprise and initiative.

THE PURE THEORY OF PUBLIC EXPENDITURE

The pure theory of public expenditure seeks to determine the optimum amount of public expenditure. Erik Lindahl sought to build a model for a simultaneous determination of the optimum amount of public expenditure and the optimum distribution of tax shares both on benefit principles. The difficulty in this model was that the optimum tax structure could not be determined without knowing the optimum amount of public expenditure, nor could the optimum expenditure be determined independent of tax structure.

The English economists developed an entirely different approach. These economists viewed the determination of public expenditure as a planning problem. They held the view that expenditure could be determined independent of revenue determination. Once the amount of expenditure has been determined, the revenue required to finance this expenditure could be determined without difficulty.

Pigou and Dalton attempted the formulation of a theory of optimum budget incorporating both expenditure and taxation. The Pigou-Dalton approach is based on the assumption that the marginal social benefit of government expenditure, optimally distributed amongst different sectors, diminishes as the amount of expenditure increases whereas the marginal social cost of taxation increases as the amount of taxation increases. Hence with the expansion of public expenditure we shall reach a break-even point where the social benefit derived from an additional amount of government expenditure is equal to the social costs of additional amount of taxation needed to finance this expenditure. Hence it is inferred that a theory of determination of the public expenditure must be based on the benefit approach particularly so in a normative theory of public finance where the supply of public goods is so planned that the community derives the greatest attainable satisfaction within its budget restraints.

Prof. Musgrave has, in fact, given us a theory of the public household where the optimum amount of public expenditure is sought to be so determined that the community is able to reach its highest possible indifference curve. This theory is based on two important assumptions: (1) The preference patterns of individuals comprising the community for goods and services as also leisure have been known and determined and (2) There is a given distribution of income in the community in the post-revenue expenditure situation which is considered ideal i.e. the distribution branch of the budget is optimally determined.

These assumptions are 'heroic' in the sense that it is very difficult, rather impossible to get the preferences of individuals revealed. But for planning of public expenditure these revelations are a 'must'. All the same, this theory of determination of public expenditure can be utilised as a guide to the determination and allocation of the two branches of the budget.

62 PUBLIC REVENUE

SOURCES OF REVENUE

A modern State taps a number of source to collect its revenue. Broadly speaking, the government revenues can be classified as (1) **Tax Revenue** and (2) **Non-Tax Revenue.**

Tax revenue derived from the various taxes: (a) Direct Taxes, *e.g.*, income-tax, wealth tax, gift tax, expenditure tax, *etc.*

(b) Indirect taxes, *e.g.*, customs duties, excise duties, sales tax, *etc.*

Non-tax revenue is derived from public undertakings called **Prices** and other miscellaneous receipts. It also raises loans, short-term and long-term, to augment its revenues.

The major sources of revenue are **Taxes and Prices.** The minor sources are **Fees, Special Assessment, Fines, Forfeitures and Escheats, Tributes and Indemnities, Gifts and Grants.**

Taxes

As we have mentioned above, that the most important source of public revenue is taxation. But taxation revenue takes several forms. It consists of taxes, fees, prices, special assessments, rates, *etc.* Let us distinguish between all these forms.

Tax. Plehn defines taxes thus: "Taxes are general compulsory contributions of wealth levied upon persons, natural or corporate, to defray the expenses incurred in conferring **common benefit** upon the residents of the State."[1] This definition brings out the true nature of a tax. The essence of a tax is (a) that it is a compulsory levy under certain conditions, and (b) it is meant for the general purposes of the State. The individual cannot expect that the State should render him a specific service in return for the tax paid by him. If I pay income-tax, I cannot claim in return that the State should post a policeman at my gate during night to protect my property which is a source of income to me.

This, however, does not mean that State undertakes to do nothing in return for the taxes that it receives from the people. The State carries on the general administration and confers lot of benefit on the community. But these are **common** benefits meant for all and not any special benefit meant for a particular tax-payer. There is no direct quid pro quo. The taxes are intended to meet the **general expenses of the government** which confer a common benefit. In the words of Taussig, "The essence of a tax, as distinguished **from other charges by government,** is the absence of any direct quid pro quo between the tax-payer and the public authority."[2]

Price. In modern times, public sector occupies a very important place in the economy. We find public enterprises being run side by side private enterprises. The government has to launch public enterprises when private sector is either unwilling or unable to enter certain fields because the return is either uncertain or it takes a long time to mature, such as multipurpose projects, railways, hydro-electric works, water works, huge iron and steel works. The government does not supply these services or goods manufactured in government undertakings free but charges a price. When public authority sells a commodity or renders a service, the charge made on the consumer, who avails of the service or buys a commodity, is called a price. Income from public enterprises now constitutes a substantial source of revenue.

Fee. It is also a compulsory payment made by those who obtain a definite service in return. The fee is intended to cover a part of the cost of the service rendered. It is never more than the cost of service. Also, some public purpose is kept in view in the

1. *Introduction to Public Finance*, 1921, p. 59.

2. *Principles of Economics*, Ch. LXVI, I.

service rendered. The obvious example is of the educational fees. In the words of Plehn, "A fee may be defined as a compulsory contribution of wealth made by a person, natural or corporate, under the authority of public power to defray a part or all of the expenses involved in some action of the government which while creating a common benefit, also confers a special benefit, or one that is arbitrarily so regarded." In short, a fee is charged for a specific service which is rendered primarily in public interest. A licence fee, however, is much more than the cost of service, and there is not much of a positive service in return.

The difference between a fee and a price is that in a fee public interest is prominent, whereas a price is a payment for a service of business character, *e.g.*, charges for travelling on State railways. You can escape the price by not purchasing a service. Price also differs from a tax. A tax is paid for a common benefit, whereas both fees and prices are paid for specific benefits.

Special Assessment is defined by Prof. Seligman as "a compulsory contribution levied in proportion to the special benefit derived to defray the cost of the specific improvement to property undertaken in the public interest." Suppose government builds a road or makes suitable drainage arrangements, all the property in the neighbourhood will appreciate in value. The State has a right to appropriate a part of this unearned increment. Special assessment is compulsory like a tax. But the tax imposed for a special purpose is called special assessment. These assessments are intended to cover a part of the extraordinary expenditure incurred by the public authority in this connection. They are levied on property proportionately to the benefit conferred.

Seligman analyses the essence of a special assessment thus: (a) there is the element of special purpose; (b) the special benefit is measurable; (c) these assessments are not progressive but proportional to the benefit received; (d) they are for specific local improvements; and (e) they are intended to extend and improve, as it were, the permanent plant of the community. Unlike a fee, there is an element of coercion in special assessment.

Rates. Rates are levied by local bodies, *i.e.*, municipalities and district boards, for local purposes. They are generally levied on immovable property of the residents but not necessarily for any special improvements effected or special benefits conferred. The rates generally vary from locality to locality.

Fines. Fines are imposed as a penalty for breaking the law. A fine is compulsory like a tax but it is imposed more as a deterrent than as a source of revenue.

Forfeitures. If an undertrial jumps a bail or a party to contract fails to carry his part of the contract, the money deposited is forfeited. The money so forfeited goes to the State. It is, however, a minor source.

Escheat. When a person dies heirless or without a successor or leaves no will behind, his property or assets will go to the State. This claim of the State to a deceased's assets is called escheat.

Tributes and Indemnities. These are paid by foreign countries. Tributes are paid by conquered countries and indemnities for any damage done to the country either by war of aggression or otherwise.

Grants and Gifts. Grants are given by a government at a higher level to that at the lower level, *e.g.*, from the Central government to the State government or from the State government to a District Board, Municipality or a Corporation. These are given for a specific purpose, *e.g.*, for economic development or some public work or for public health or education.

Gifts are received either from governments or some private bodies or individuals. Gifts are sometimes received from foreign governments for relief in natural calamities like earthquake, floods, droughts, cyclones, *etc.* Donations are given by individuals for specific purposes such as building a hospital or relief fund.

CLASSIFICATION OF TAXES

Taxes have been variously classified. Some classifications are given below:—

Taxes may be proportional, progressive, regressive and degressive.

Proportional Tax

A proportional tax is one in which, whatever the size of income, same rate or same percentage is charged. If all the tax payers have to pay, say one per cent of their income as tax, it is a case of proportional taxation. The same percentage is charged from all tax-payers.

Progressive Tax

If, on the other hand, the rate of the tax rises as the taxable income increases, the tax is called a progressive tax. The principle of a progressive tax is: "higher the income, higher the rate."

It is worth noting that, even under proportional tax, the richer man pays more. For example, if the rate is 1 per cent on the monthly salary, a man who is getting Rs. 500 p.m. will pay Rs. 60 per year and the man who is getting Rs. 600 p.m. will pay Rs. 72 per year. Thus, the man with the higher income pays more even under the proportional taxation. But, under progressive taxation, he will pay much more because as income increases, the rate of the tax must also increase. The man with Rs. 600 monthly salary may have to pay 2 per cent instead of 1 per cent. He will pay, therefore, Rs. 120 instead of Rs. 60

per year. All countries have adopted the progressive system of taxation, as it is considered more equitable. This is due to the fact that the sacrifice entailed in proportional taxation is less than it ought to be. We shall consider the pros and cons of progressive taxation in a subsequent section.

Regressive Tax

A tax is said to be regressive when its burden falls more heavily on the poor than the rich. It is the opposite of a progressive tax. No civilised government imposes a tax in which, as income increases, the rate of tax is lowered. That would be palpably unjust. But there are several taxes on commodities whose burden rests mainly on the poor. The Indian salt tax was regarded as a regressive tax, as it pressed more heavily on the poor than on the rich. As a matter of fact, the rich man did not feel it at all.

Degressive Tax

A tax is called degressive when the higher incomes do not make a due sacrifice, or when the burden imposed on them is relatively less. This will happen when a tax is only mildly progressive, *i.e.*, when the rate of progression is not sufficiently steep. A tax may be progressive up to a certain limit beyond which a uniform rate is charged. In that case, there will be a lower relative sacrifice on the larger incomes than on the smaller incomes.

Direct and Indirect Taxes

Another classification of taxes is as **Direct Taxes** and **Indirect Taxes.** In the case of a direct tax. the man who pays it is also intended to bear it. But an indirect tax is expected to be shifted to other persons. If I pay income-tax, I have to bear it. I cannot pass it on to somebody else. It is a **direct tax.** But if a tax is imposed on sugar, the dealer who first pays it, charges it from the next buyer till ultimately it is borne by the consumers of sugar. The tax has been shifted. It is called an **indirect tax.**

In the case of direct taxes, as Mrs. Hicks explains, the liability varies with the circumstances of the tax-payer and the relation between the tax-payer and the revenue authorities is direct and personal. But, in the case of indirect taxes, the liability depends on the amount or value of a particular product or service bought. Here there is an indirect relation between the tax-payer and the revenue authorities, for the taxes are collected unofficially through the agency of merchants. Direct taxes are taxes on income and indirect taxes are taxes on outlay.

We shall discuss the merits and demerits of direct and indirect taxes in a later chapter (No. 64).

Specific and Ad Valorem Taxes

Taxes may also be classified as **specific** and **ad valorem taxes.** A specific tax is according to the weight of the commodity. An **ad valorem** tax is according to its value. If imposed on coarser or cheaper articles, the specific duties mean a heavier burden and are considered regressive in character. But they are simpler to administer. For the administration of ad valorem duties an elaborate administrative machinery is needed. The invoice has to be checked and a host of appraisers needed for evaluating the goods.

CANONS OF TAXATION

Adam Smith's Canons

Adam Smith's contribution to taxation part of economic theory is still regarded as classic. His statement of the canons of taxation has hardly been surpassed in clarity and simplicity. Adam Smith's canons still constitute the foundation of all discussions on the principles of taxation. We give below his four celebrated canons:

(i) **Canon of Equality.** "The subjects of every State ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the State."

This canon embodies the principle of equity or justice. This is the most important canon of taxation. It lays the moral foundation of the tax system. The canon of equality does not mean that every tax-payer should pay the same sum. That would be manifestly unjust. Nor does it mean that they should pay at the same rate which means proportional taxation, and a proportional tax is also not a just tax.

What this canon really means is the **equality of sacrifice.** The amount of the tax paid is to be in proportion to the respective abilities of the tax payers. This clearly points to progressive taxation. Adam Smith makes this clear in a subsequent portion of his book **Wealth of Nations.** He says: "It is not very unreasonable that the rich should contribute to the public expense not only in proportion to their revenue but something more than that proportion."[3] Only then, the tax will be in proportion to the ability to pay.

(ii) **Canon of Certainty.** "The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid ought all to be clear and plain to the contributor and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax-gatherer, who can either aggravate the tax upon any obnoxious contributor, or extort, by the terror of such aggravation, some present or perquisite to himself."

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3. *The Wealth of Nations*, Book V, Vol. II, p. 327.

Uncertainty in taxation, according to Adam Smith, encourages insolence or corruption. He regards this canon as very important, for in his view "very considerable degree of inequality . . . . is not near so great an evil as a very small degree of uncertainty." Hadley also regards it as the most fundamental canon, for, according to him, all attempts at equality will prove illusory without the taxes being certain.

The canon of certainty demands that there should be no element of arbitrariness in a tax. It is not to be left to the caprice or the sweet will of the income-tax department. The tax-payer should be able to see for himself why he is called upon to pay a particular sum. That is why wide publicity is given to the budget proposals and discussions thereon. The passing of the budget is a guarantee of certainty.

"An old tax is no tax" is a maxim of taxation which issues out of the canon of certainty. An old tax is well known, its reactions are certain and the people are supposed to have made the necessary adjustments. The tax is not felt. It causes the least disturbance in the economic arrangements of the tax-payer. There is little inconvenience from an old tax.

Certainty is needed not only from the point of view of the tax-payer but also from that of the State. The government should be able to estimate roughly the proceeds of the various taxes proposed to be levied and the time when they are expected to flow in. Only then the government can follow its financial programme.

(iii) **Canon of Convenience.** "Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it."

The canon of certainty says that the time and the manner of payment should be certain. But the canon of convenience says that the time of payment and the manner of payment should be convenient. If a tax on land or house is collected at a time when rent is expected to be paid and acceptable by cheque, the manner is convenient, but not so if it is to be paid personally to the taxing authority. In the latter case, there will be a lot of inconvenience and harassment.

Taxes on consumers are very convenient. The consumer pays them when he makes purchases and at a time when he can afford to pay because the purchaser chooses his own time for purchasing. The manner is also very convenient for he has to make no special arrangement for paying a tax. He pays it when he buys the commodity. The tax is wrapped up in the price of the commodity.

The Indian land revenue conforms to the canon of convenience, because it is paid in instalments and after the harvest time. Income-tax, on the other hand, infringes the canon of convenience. The assessee has to take his account books to the tax officer in order to satisfy him about the accounts. This necessitates a series of personal interviews with consequent loss of time. It also involves a lot of trouble and oppression.

(iv) **Canon of Economy.** "Every tax ought to be so contributed as both to take out and to keep out of pockets of the people as little as possible, over and above what it brings into the public treasury of the State."

One implication of the canon of economy is very obvious. The tax is economical if the cost of collecting it is very small. If, on the other hand, the salaries of the officers engaged in collecting the tax take away a big portion of the tax revenue, the tax is certainly uneconomical. As far as possible, as much should come into the State treasury as is taken out of the people's pockets. Nothing should evaporate in the way. If there is corruption or oppression involved in the frequent visits to the income-tax office and the odious examination by the taxing officer, the canon of economy is not satisfied.

But the tax should also be economical in another, perhaps broader, sense. It would infringe the canon of economy, if it retarded the development of trade and industry in any manner. If incomes are subjected to a very heavy tax, saving may be discouraged, capital will not accumulate and the productive capacity of the community will be seriously impaired. This would obviously be uneconomical. A tax is economical if it does not hamper in any manner the economic progress of the country.

Taxes on harmful drugs and intoxicants are regarded as economical, because they not only bring income to the State, but also discourage unproductive expenditure. But taxes on raw materials are uneconomical because they raise the price of the manufactured goods and weaken the competitive power of the industry. Also, every middleman goes on adding something to the tax that he has paid.

The first canon of Adam Smith is ethical and the other three are administrative in character.

Other Canons

Since Adam Smith wrote, the science of Public Finance has continued to grow. Subsequent writers have added canons of their own to his four canons. The following are some of those which have been subsequently added:

(v) **Fiscal Adequacy or Productivity.** The State should be able to function with the revenue raised from the people by means of taxes. The government should be free from financial embarrassments. It will be necessary, therefore, that the tax proceeds should adequately cover the government expenditure and the government does not run into a deficit. But the government should also not err on the side of excess. In their zeal to raise more revenue, they should not cripple, in any manner, the productive capacity of the community or impair the economic resources of the country.

The canon of productivity would indicate that a few taxes bringing a large revenue are better than many taxes each bringing a very small revenue. Too great a multiplicity of taxes is to be avoided, because each tax is likely to cause some vexation to the citizens. But here again, we must warn that the principle of concentration should not be carried to excess, otherwise it may become either uneconomical or inequitable.

(vi) **Elasticity.** The canon of elasticity is closely connected with that of fiscal adequacy. As the needs of the State increase, the revenue should also increase otherwise they will cease to be adequate. To meet an emergency or a period of stress and strain, the government should be in a position to augment its financial resources. Some of the taxes should be capable of yielding more if need be. Income-tax is a very good example of an elastic tax. By raising the rate a bit or by levying a surcharge, the yield from income-tax can be considerably increased.

(vii) **Flexibility.** The canon of flexibility looks like that of elasticity but the difference between the two is quite clear. Flexibility means that there should be no rigidity in the tax system so that it can be quickly adjusted to new conditions, and elasticity means that the revenues can be increased. Unless the system is flexible, the revenue cannot be increased, for alterations will not be possible. Thus, presence of flexibility is a condition of elasticity. If a tax system cannot be altered without bringing about a revolution, it lacks flexibility.

The Permanent Settlement of Bengal (1793) is an example of rigidity or lack of flexibility in a tax. Under this arrangement, the Government bound itself to collect the same sum from the land-owners in perpetuity. The lack of flexibility was, in no small measure, the cause of the financial troubles of Bengal.

(viii) **Simplicity.** In the words of Armitage Smith, "A system of taxation should be simple, plain and intelligible to the common understanding." This canon is essential if corruption or oppression is to be avoided. If a tax is complicated so that the tax-payer cannot understand how much he is to pay and why he is to pay it, a great power will pass into the hands of the tax-gatherers. The door will be widely opened to corruption and oppression.

(ix) **Diversity.** Another important principle is that of diversity. A single tax or only a few taxes will not do. There should be a large variety of taxes so that all the citizens, who can afford to contribute to the State revenue, should be made to do so. They should be approached in a variety of ways. There should be a wise admixture of direct and indirect taxes. In this manner, the canons of fiscal adequacy and equity may be better satisfied. But too great a multiplicity will be bad and uneconomical.

(x) **Achievement of Social and Economic Objectives.** Considering the role that taxation is called upon to play in modern times, another principle is being emphasized, *viz.*, that the effects of taxation should be compatible with the economic and social objectives that the community has placed before itself and with the institutions and processes considered essential for the attainment of these objectives.

The neutrality principle or 'leave-them-as-you-find-them' principle no longer holds the field. The taxation policy today has to be more positive. It is intended to bring about economic stability and development besides the attainment of other political and social goals. In conjunction with economic controls and monetary measures, taxation has to be freely used to combat threats of economic instability and stagnation by means of a "managed compensatory fiscal programme."

It was Adolph Wagner, a German economist, who in his book **Finanzwissenschaft,** published in 1880, developed a "social compensatory or social political theory of taxation" for the purpose of reducing economic inequalities. The application of this theory can be seen during the depression dilemma of the 'thirties and during and after the Second World War when taxation was used as a tool for fighting inflation.

Several other considerations have been put forward. It is recommended, for instance, that a tax should fall on revenue and not on capital. It should not cut down the minimum subsistence of the tax-payer, and so on.

SOCIAL AND ECONOMIC OBJECTIVES OF TAXATION

Among the social and economic objectives of taxation, the following principal ones may be mentioned:

(a) **Reduction of Inequalities in Income and Wealth.** One of the main objectives of taxation is to reduce, if not to remove, inequalities of income and wealth. For this purpose, steeply progressive taxes must be levied on the affluent sections of society. This is the trend in all democratic countries.

(b) **Accelerating Economic Growth.** Another important objective is to accelerate economic growth. For this purpose, the tax system must be so designed as to raise the rates of saving and investment. This is a very important objective for developing economies like India. But in the developed economies, during periods of depression, the aim is to increase consumption and reduce saving so that aggregate demand may increase and remove depression, and the prevailing unemployment may diminish. On the contrary, when there is inflation, the objective of taxation policy is to reduce consumption (*i.e.*, to

increase saving) so that aggregate demand may diminish and price rise is checked.

(c) **Price Stability.** In under-developed countries, there is another objective that the tax system has to achieve, *viz.*, price stability to ensure growth with stability. When these countries launch economic development programme they have to face the problem of inflation or soaring prices. They should follow an integrated tax policy to solve this problem.

Objectives in a Developing Economy

A dominant aim of under-developed countries is to accelerate economic development. This calls for a rational reorganisation of their tax system on the basis of the concept of functional finance. The tax policy of such countries is to be attuned to the raising of resources required for development. In the developed countries the aim is to ensure economic stability and to avoid economic fluctuations. But the aim in the under-developed countries is to ensure rapid economic growth, and taxation is to be used as an instrument of economic progress. Accordingly, the under-developed economies must ensure collective savings (raising the ratio of savings to national income) through taxation, because in such countries saving is not practised voluntarily. But mere saving is not enough; the savings must be invested.

Thus the tax policy must strengthen incentives to savings and investment. The traditional canons of taxation developed in the West will not serve the purpose. The under-developed countries have to act on different canons.

Take the case of the canon of 'ability to pay'. In the realm of theory of taxation, this canon still enjoys pride of place among the canons of taxation. This is favoured because it leads to progressive taxation and results in reduction of inequalities. But the question of reduction of inequalities must be taken up separately keeping in view the requirements of a developing economy. From the point of view of development, taxation is not to be viewed as solely a contribution to meet the costs of common services rendered by the State. It is to be viewed rather as a powerful tool to raise the rate of investment in the economy.

The following few canons of taxation may be suggested as more appropriate to a developing economy:—

(i) **Ability to Contribute to Economic Development.** Each person should be made to contribute to economic development, according to his ability to do so. All his unused capacity must be utilised, through appropriate tax measures, for purposes of economic development. Suppose a person is making a large saving but he lets it lie idle. Such saving must be mobilised and channelised into investment. The Compulsory Deposit Scheme (later replaced by Annuity Deposit Scheme) in India and Cumulative Time Deposit in post offices promote this purpose. If a person's income exceeds what is required to maintain his efficiency and incentive (*i.e.*, willingness and ability to work and save), this excess must be taken away and used for economic development, of course on reasonable compensation.

(ii) **Mobilization of Economic Surplus.** In all backward economies, a significant proportion of national output goes to the big landlords and the other idle rich or propertied people. A large portion of their income is spent on conspicuous consumption, *e.g.*, building of palaces, *etc.* This is unproductive expenditure and a waste from the point of national development. Economic growth can be accelerated if an appreciable portion of this 'surplus' income is mobilised and made available for productive investment.

Hence, an important canon of taxation in a developing economy is the mobilisation of economic surplus generated in the various sectors of the economy.

(iii) **Increasing the Incremental Saving Ratio.** As economic development proceeds apace, incomes rise. But there is a danger that propensity to consume may also increase so that extra incomes generated in the economy are utilised in consumption rather than invested in production. This has to be prevented. In other words, consumption is not to be allowed to increase in proportion to increase in incomes. Thus, taxation must also mobilise any increase in economic surplus accruing to individuals. For achieving this purpose commodity taxes are quite effective.

(iv) **Income Elasticity of Taxation.** In backward economies, the share of taxation out of the national income is less than 10 per cent. This share must be progressively raised as national income increases as a result of economic development. This needs built-in flexibility in the tax system. Progressive taxation of incomes provides this flexibility. Taxation of goods having a high income-elasticity of demand also imparts to the tax system much needed flexibility.

(v) **Equity.** The canon of equity demands that the burden of economic development must be distributed among the different sections of the community equitably. That is why the richer classes are prevented from increasing their consumption in proportion to the rise in their incomes. This is how they make a sacrifice for the economic development of their country. The poor people also make a sacrifice because rising prices curtail their consumption. In this manner, sacrifices in consumption are shared by all sections of the people. Thus, the burden of economic development is equitably distributed among all. There is what is called the **'rule of horizontal equity'** according to which persons in similar circumstances and with similar economic behaviour (in terms of utilisation of economic

surplus accruing to them) must be treated alike for purposes of taxation.

These are a few of the principles which must underlie the tax system of a developing economy.

CHARACTERISTICS OF A GOOD TAX SYSTEM

A good tax system should be composed of taxes which conform to the canons of taxation discussed above. The system, as a whole, should be equitable. Its burden should fall on the broadest shoulders. It should also be economical so that the work of collection of taxes is done as cheaply as possible. It should not hamper the development of trade and industry. There should be as little interference with economic decisions in otherwise efficient markets. It may, however, rectify inefficiencies in the private sector. It should, on the other hand, fulfil the growth and stabilisation objectives of the country. The government should be certain of its revenue. The tax system should be based on a comprehensive and up-to-date statistical information so that accurate forecasting is made possible. The tax system should not be a mere leap in the dark. Its effects should be calculable with reasonable precision. That is, it should make for an efficient and non-arbitrary administration. The taxes, as a whole, should be **convenient**, *i.e.*, felt as little as possible.

The tax system should be simple, financially adequate and elastic. In other words, the system should be easily intelligible; it should be sufficiently productive of revenue; and the tax structure should be adaptable to meet the changing requirements of the economy. It should not be rigid like our land revenue which is fixed for 30 or 40 years. The adoption of the sliding scale system of land revenue in the Punjab removed this defect to some extent.

It is agreed that the tax system should be as much broad-based as possible. It should be multiple tax system. There should be diversity in the system. But we do not want too great a multiplicity. We do not agree, therefore, with Arthur Young when he says, "If I were to define a good system of taxation, it should be that of bearing lightly on an infinite number of points, heavily on none."

Further, the tax system should be **efficient from the administrative point of view.** It should be simple to administer. There should be little scope for evasion or accumulation of arrears. It should be foolproof and knave-proof. Chances of corruption should be minimised.

A good tax system should appreciate the rights and the problems of the tax payers. It should not be unnecessarily vexatious. It should cause minimum inconvenience and interference in their economic life. There should be provision for a prompt and fair disposal of their complaints and appeals.

Another important characteristic of a good tax system is that it should be a harmonious whole. It should have a balanced structure. It should be truly a system and not a mere collection of isolated taxes. Every tax should fit in properly in the system as a whole so that it is a part of a connected system. Each tax should occupy a definite and due place in the financial structure. The taxes should not pull in different directions. For example, imposition of a protective duty and a countervailing excise duty do not go well together.

A very important characteristic of a good tax is that it should be an **instrument for the reduction of economic inequalities.** The purpose of public finance is not merely to raise revenues for the State but to raise the revenue in such a manner as to ensure that the burden of tax should fall on the rich. That is why income tax, wealth tax, death duties, *etc.*, are imposed at progressive rates. They do not bring about complete economic equality, that perhaps is neither feasible nor desirable but inequalities are undoubtedly lessened so that the gulf between the 'haves and have-nots' is narrowed down. This effect will be further heightened if the revenues raised from the rich are spent for the benefit of the poor.

From the point of view of ensuring **economic stability,** it is necessary that the tax system must be progressive in relation to changes in the national income. This means that when national income rises, an increasing part of the rise in income should automatically accrue to the tax authorities and when national income falls, as in a depression, the tax revenue should fall faster than the fall in national income.

This characteristic of the tax system will ensure that when national income is increasing, as during the boom, a large part of it is being drawn into the tax net so as to moderate the rise in purchasing power of the people, helping thereby to keep the price-rise in check. Similarly, in depression, tax revenues should fall faster than income so that the purchasing power of people does not fall as fast as their pre-tax income. This will serve to moderate the extent of decline in economic activity during a depression. Thus, an overall progressive tax system is an important factor in ensuring stability.

For developing economies, the tax system has to serve as an **instrument of economic growth.** Economic development rather than economic stability is the objective of under-developed economies. Their tax system must be so shaped as to accelerate economic development. For this purpose, it must mobilise the required resources and channelise them into investment. It must, in short, step up savings and investment and raise the level of income and employment in the country.

Besides, the tax system should be **socially advantageous** and promote general economic welfare. From this point of view, taxes on goods of mass

consumption should be avoided. The burden of the taxes should not be excessive.

Optimum Allocation of Resources. The tax system should be so framed as to ensure that the productive resources of the economy are optimally allocated and utilised. For this purpose, it is essential that the tax system should be economically neutral. In other words, it should interfere as little as possible with the consumers' choices for consumption goods and the producers' choices regarding the use of factors. The owners of factors should be enabled to seek their most remunerative employment. The price mechanism should be allowed to operate freely so that there is optimum output of goods. It can be understood that the imposition of a tax leads to diversion of resources from the taxed to the non-taxed sector. This reallocation of resources may be a departure from the optimum utilisation of resources. Hence, the nature of the taxes and the rate of taxes should be such as to ensure optimum utilisation of resources.

Above all, the tax system should conform to the principle of maximum social advantage so that the society as a whole is benefited to the maximum extent possible.

Conclusion

It may, however, be emphasised in conclusion that no tax system in the world can satisfy all the criteria of a good tax system mentioned above. Some of the objectives conflict with one another, whereas others are complementary. For instance, too high progressiveness in the tax system may reduce inequalities but they may also reduce national output and employment by damaging productive efficiency. Similarly, protective import duties may promote industrial development but they may reallocate productive resources in such a manner as to depart from the optimum. The best thing to do is to adapt the tax system to the prevalent economic situation and to make it conform to aims and objectives considered most desirable under the circumstances.

Evaluation of the Indian Tax System

According to Kaldor, who was invited to report on the Indian tax system, there are three main considerations that should be taken into account in framing an effective tax system, *viz.*, **equity, economic effects, administrative efficiency.**

From the point of view of equity, the most important consideration is that the tax system should not contain a systematic bias in favour of particular groups of tax-payers and against others. From the point of view of economic effects of taxation, the major consideration is to prevent the tax system from becoming too much of a disincentive on effort, initiative or enterprise. From the point of view of administrative efficiency, all loopholes for evasion should be plugged and the main requirements are: simplicity and comprehensiveness embracing all forms of beneficial receipts, a single comprehensive return, self-checking system of taxation and an automatic reporting system.

According to Kaldor, the present system of direct taxation in India is, however, both inefficient and inequitable. It is inequitable because the present base of taxation, *i.e.*, income, as defined in law, is defective and is capable of being manipulated by certain classes of tax-payers. It is inefficient because of the possibility of large-scale evasion on account of the limited information furnished by tax-payers and on account of the absence of any comprehensive reporting system on property transactions and property income.

Kaldor made proposals which aimed at broadening the tax base through the introduction of an annual tax on wealth, a tax on capital gains, a general gift tax, and a personal expenditure tax. All these five taxes were to be assessed simultaneously on the basis of a single comprehensive return and they are self-checking in character so that concealment or understatement of income from certain items will involve an added liability with regard to others. He says that it is far better to have a foolproof system of taxation with a moderate rate schedule than a system which has the appearance of high progressivity, but which cannot be effectively or impartially administered.

Judged from the point of view of economic development, however, the tax effort in India has been quite satisfactory. The ratio of savings to national income has been going up. It has been estimated that 25 per cent of the increase in incomes (*i.e.*, marginal savings rate) has been saved which is quite commendable. The investment has been going up by leaps and bounds as from one five-year plan to another. The second plan outlay was more than double of the first and the third more than double of the second and the fourth plan more than the three earlier plans combined.

ROLE OF TAXATION IN DEVELOPING ECONOMIES

For under-developed or developing countries, it is very essential to have an appropriate taxation policy, if economic growth is to be accelerated. In the absence of a suitable tax policy, the rate of economic growth is bound to be tardy. In modern times, the aim of public finance is not merely to raise sufficient financial resources for meeting administrative expenses, for maintenance of law and order and to protect the country from foreign aggression. On the other hand, the sphere of public finance has been very much extended. It is now considered a powerful instrument in the hands of the State for the achievement of important economic and social objectives. The most important

objective before these countries is to accelerate their economic growth.

The under-developed countries, like India, are caught up in the vicious circle of poverty. Consequently, such countries are not able to save much, whether we consider individual savings or collective savings by corporations and firms. Their annual savings are only a small fraction of their national income. In India, the rate of domestic savings has been projected to grow from 12.2% of G.N.P. in 1973-74 to 15.7 per cent in 1978-79. In the same period, the rate of investment is expected to rise from 13.7 per cent of G.N.P. in 1973-74 to 16.3 per cent of G.N.P. in 1978-79. But our annual rate of growth has been round about 3 per cent. This means that a much greater tax effort is called for to raise our growth rate to a reasonable level. Since private savings and capital formation are meagre in India, the responsibility of resource mobilisation for economic growth falls on the State. That is why the role of public finance in developing countries is very important.

For accelerating economic growth, the government has to adopt a tax policy which may raise the rates of saving and capital formation in the country. Since private investment is not adequate for the purpose, the government has to make up the deficiency of private investment by increasing public investment and for that purpose raise resources through taxation.

There are several advantages of increasing savings and investment through taxes:

(a) Taxation is the only effective weapon by which private consumption can be curbed and thus resources transferred to the State.

(b) Through taxation inequalities in income and wealth can be reduced.

Since developing countries like India have a mixed economy, care has also to be taken that capital formation and investment in the private sector is not discouraged. The primary objective of tax policy is, therefore, to promote investment both in the private and public sectors. Taxation policy is to be directed to raising the ratio of savings to national income. Hence, such taxes should be levied as encourage savings and investment. If the people do not make savings out of their increasing incomes, then the government should take away from them a part of their income through taxes and invest it in development programmes. In other words, taxes result in forced saving.

Tax Policy for Developing Economies

It is natural that a tax policy which is appropriate for developed countries may not suit the under-developed or developing countries. This is due to several reasons:

(a) America and the countries of Western Europe have already reached the height of economic development. Their aim is now to avoid economic fluctuations, *i.e.*, ups and downs in business. That is, they need economic stability. In other words, they want to maintain their present level of income and employment. On the contrary, the primary objective of under-developed countries, like India, is to achieve a higher standard of economic development.

(b) The developed countries pay greater attention in their tax policy to ability to pay or equity; but in the under-developed countries more attention is given to the amount of revenue raised and practicability.

(c) The governments in developed countries generally pursue the policy of laissez-faire in economic matters. On the other hand, the governments in developing countries have to intervene to make sure that the productive resources, are utilised in strategic or key industries and in other essential economic activities.

(d) Whereas, the objective of developed countries is to reduce inequalities in income and wealth distribution, the primary objective of the developing countries is to accelerate economic growth.

Hence, under-developed countries should not borrow or imitate the tax policies adopted in the developed countries.

It does not follow from the low per capita income of the under-developed countries that the rate of savings must also necessarily be low. Even in under-developed countries, there are many rich people like big industrialists, big landlords and owners of vast urban property. They enjoy large incomes out of which sizable savings can be made. But since these savings generally seek investment in jewellery and real estate, they are not utilised for economic development. If these economic surpluses are mobilised through taxation and used in productive investment, economic development can be accelerated beyond doubt.

If an economy enjoys an economic surplus after satisfying consumption needs, it can be expected to develop economically. Economic surplus is the difference between current output and essential consumption. Some countries waste this surplus in unproductive consumption, *e.g.*, maharajas building palaces. In agriculturally predominant countries, such surpluses go into the hands of big zamindars, sahukars and big businessmen, who have no experience of utilising them for productive investment. The bulk of their wealth is squandered in marriages and house building. It is the task of the tax policy of a developing country to mobilise the economic surplus, direct it into productive investment and enlarge it.

So far we have referred to direct taxes. Now let us

take indirect taxes. In under-developed countries, indirect taxes occupy a relatively more important position than direct taxes. We have to see how these taxes should be levied so that they not only yield revenue to the State but also encourage investment in economic development programme. The question is whether commodities of mass consumption should be taxed or not. It is argued that the incomes of poor people are already very low; hence these commodities should not be taxed. But this argument is not valid. Such taxes have great importance for economic development, because only by means of these taxes, increase in consumption can be checked as incomes increase and thus saving can be increased which can be used in economic development.

Indirect taxes promote economic development in three ways:

(i) They check consumption of luxuries and use the saving so made for economic development;
(ii) they mobilise resources for public sector investment; and
(iii) they increase the savings ratio.

For the achievement of these objectives, taxation is used for (a) diversion of resources from private to the public sector, (b) diversion from consumption goods industries to investment goods industries, and (c) diversion of demand for import goods to export goods.

The Theory of Tax Structure Development

It is common knowledge that tax structure has undergone changes from time to time. The theory of tax structure seeks to explain changes in tax structure of an economy over time under the impact of economic development and of political and social factors.

To take economic development first. Tax structure is affected by economic development in three ways: (a) Tax base undergoes a change as the developmental process proceeds; (b) change in the tax base brings about changes in the revenue system; and (c) Economic development leads to changes in the objecives of tax policy.

Changes in Tax Structure Under the Impact of Economic Development

Earlier Stages of Development. In the beginning, we find that these countries are predominantly agricultural and have a slender industrial base. But since agriculturists have low taxable income, it is difficult to reach this sector through income taxation. As regards the industrial sector, since the manufacturing base is thin, the effective tax has to be confined to large-scale establishments.

At this stage following guidelines are indicated: (1) There should be inter-locking of taxes to ensure better tax compliance. That is, a tax on income should be accompanied by expenditure tax and wealth tax. And there should be simultaneously an estate duty and gift tax. (2) There should be a system of fines and penalties for tax evasion and under-reporting. There should be adequate administrative devices to minimise opportunities of tax evasion. Greater emphasis should be put on commodity taxes because they cannot be evaded. New tax bases like foreign trade sector should be tapped.

Changes in the Later Stages of Development. As a result of economic development, there are three distinct changes in the tax structure: (a) Since the economy becomes monetised, a broader tax base becomes available as a large volume of output and income pass through the market.

(b) There is a wider scope for indirect taxation as consumption and exchange of commodities increases.

(c) As economic development takes place, there is improvement in the accounting practices of businessmen making for better assessment of business incomes and taxation. Taxation of incomes becomes more efficient and effective.

Inspite of these improvements, the tax-structure suffers from two serious drawbacks: In the first place, the tax system suffers from the weakness of administrative machinery. As the scope for taxation becomes wider tax collection becomes more complicated. Multiplicity of taxes creates legal and institutional problems from the variety of ways in which incomes are received and outlays made. For instance, estate duty and gift tax give rise to many technical problems. In the early stages of economic development, the problem was how to assess an "elusive herd of cows," but in the later stages the problem is how to assess an "elusive flow of capital". Devices like holding company, trust arrangements, etc. add to the difficulties of the tax administration.

As for social and political factors affecting the development of tax structure, we might say that under feudalism property was an ideal base for taxation. As feudalism gave place to modern capitalism, property as a base for taxation was relegated to the back ground and its place was taken by income as a base for taxation. Under a predominantly agricultural economy, land taxes were supreme. But as trade and industry developed, sales and excise duties occupied a pride of place, Under the impact of social philosophy, equity started bothering the taxation authorities.

63 PROBLEM OF EQUITY

"It is equitable that people in the same economic position should be treated in the same way for purpose of taxation." But how to measure economic position? In order to achieve the ideal of justice in taxation several principles have been suggested. We examine some of these principles below:

Cost of Service Principle

It is said that it would be just if people are charged the cost of the service rendered to them. However equitable it may appear to be, 'the cost of service principle' cannot be applied in actual practice. The cost of service of the armed forces, police, *etc.*— the services which are rendered out of tax proceeds—cannot be exactly determined. We have to calculate how much it costs to render a service to the particular tax-payer.

We know that in case of taxes there is no direct quid pro quo to the tax-payer. Hence, the question of ascertaining the cost of service to an individual tax-payer does not arise. Only in those cases, where the services are rendered out of prices, *e.g.*, supply of electricity, railway or postal service, a near approach can be made to charging according to the cost of service. Even here the exact cost cannot be ascertained, and for fixing the charges, we have to fall back on the principle of "charging what the service will bear."

The cost of service principle, therefore, must be rejected as being impracticable.

Benefit or 'Quid Pro Quo' Theory

It is suggested that the taxes should be levied according to the benefit conferred on the tax-payers. But on grounds similar to those mentioned above, the benefit theory also breaks down when an attempt is made to give it a practical shape. Most of the public expenditure is incurred for common or indivisible benefits. It is impossible to calculate how much benefit accrues to a particular individual. There are a few cases only where the benefit to the individual is ascertainable, *e.g.*, old-age pensions. Applied to this case, the theory would demand a refund of the pension itself, for that precisely is the measure of the benefit. Nobody would seriously put forward such a proposal. It is, therefore, impossible to ask the people to contribute according to the benefits received by them.

Several other objections can be raised against the Benefit Theory. It is against the basic principle of the tax. A tax is paid for the general purposes of the State and not in return for a specific service. The Benefit Theory can have meaning only if we think of the benefit to the community as a whole. But this is obviously useless for the purpose of taxing the individual. If you want to make some exceptions, you will be in a difficulty. On what basis will you make the exceptions?

Moreover, it is commonly believed that the poor benefit more from the State activities than the rich. If that is so, then to apply the 'Benefit Theory' would mean making those people pay who cannot afford to pay and letting off those who can and who should. This would be absurd.

In the words of Plehn, "Common benefits are the peaceful enjoyment of life, liberty and property." So far as life and liberty are concerned, the benefit of State protection is the same for all. This would indicate a uniform tax, say a poll tax. But poll tax has been long discarded on account of its relatively small yield and greater cost and botheration of collection. If we take protection of property as the basis, then it should be a proportional tax, proportionate to the capital value or the income yielding capacity of the property. But proportional taxation has also been rejected in modern times as being less than just. We cannot, therefore, take benefit as a criterion of justice.

The Benefit Theory has, however, a place in all modern tax systems. The idea of benefit stands out

prominently in the case of fees, licences, special assessment and local rating.

'Ability to pay' or Faculty Theory

The most popular and the plausible theory of justice in taxation is that every tax-payer should be made to contribute according to his ability or faculty to pay. The tax is to be based on his taxable capacity. Nothing would appear to be more just. But the acceptance of the principle does not mean the end of our difficulties; rather the difficulties begin. The question which we then face is: "What is the measure of a man's ability to pay?'

In the search for a proper criterion of a person's ability to contribute to the State exchequer, we can proceed on two lines, subjective and objective:

Subjective Approach. If we examine the position of the tax-payer in its subjective aspect, we shall consider the inconvenience, the pinch or the sacrifice involved. On this point, three distinct views have been advanced: (a) The Principle of Equal Sacrifice; (b) The Principle of Proportional Sacrifice; and (c) The Principle of Minimum Sacrifice.

In the words of J.S. Mill, "Equality of taxation, as a maxim of politics, means equality of sacrifice. It means apportioning the contribution of each person towards the expenses of government, so that he shall feel neither more nor less inconvenience from his share of the payment than every other person experiences from his."[1] According to this principle, the money burden of taxation is to be so distributed as to impose equal real burden on the individual tax-payers. This would mean proportional taxation.

According to the principle of **proportional sacrifice,** the real burden on the individual tax-payer is to be not equal but proportional either to their income or the economic welfare they derive. This would be more just than if the sacrifice involved were equal. Those who can make a greater sacrifice should be asked to do so. This would mean progressive taxation.

The **minimum sacrifice principle** considers the body of tax-payers in the aggregate and not individually. According to this principle, the total real burden on the community should be as small as possible.

In the words of Edgeworth, the chief exponent of the theory of minimum aggregate sacrifice, "The minimum sacrifice is the sovereign principle of taxation. If one is a utilitarian and believes not only in the measurability of utility but also in the view that the law of diminishing marginal utility is applicable to money also, then this principle would involve a high level of minimum exemption and a very steep progression as income increases. This is because if we assume that marginal utility of money falls as income increases, then money has less marginal utility to the rich than to the poor. And assuming that a given tax revenue is to be collected, it would involve least aggregate sacrifice if this tax revenue were to be collected from the people in the higher income brackets. The less the aggregate sacrifice the better the distribution of the tax burden in the community. The State exists to maximize human welfare. This it will be able to do by minimizing the sacrifices involved."

Objective Approach. We must, therefore, take our second line of approach to measure a man's faculty to pay, that is, proceed objectively. Here we are on surer grounds. But here again, we find that several criteria have been suggested. A man's faculty to pay may be measured according to (a) consumption, (b) property, or (c) income.

Consumption, as a criterion of ability to pay, is not a sound criterion, because consumption or utilisation of the services of the State by the poor is considered to be out of all proportion to their means, and, as such, it cannot be taken as a practical principle of taxation.

Property also cannot be a fair basis of taxation, for properties of the same size and description may not yield the same amount of income; and some persons having no property to show may have large incomes, whereas men of large property may be getting small incomes. Thus, to tax according to property will not be taxation according to ability.

Income, however, remains the single best test of a man's ability to pay. But even in the case of income, the tax will be in proportion to faculty, if there is a minimum exemption to allow for a reasonable subsistence, if there is an allowance made for the number of dependants, and, finally, if the principle of progression is applied by taxing the rich at a higher rate.

Besides, we have to consider 'the ability to pay' not merely of the individual tax-payer but of the community as a whole. In this light, it is necessary that the tax system as a whole is not oppressive. It should not discourage saving or retard accumulation of capital. Also, it should not, in any manner, impair the productive capacity of the community by hampering the development of trade and industry in the country.

Summing up. This is the solution of the problem of justice in taxation. The ends of justice are not served by applying the cost of service principle or by taxing according to benefit, but according to faculty or ability to pay. The ability to pay cannot be judged subjectively by the amount of sacrifice involved, but objectively according to the man's income and not according to his consumption or property. What is intended is that the tax system as a whole should be equitable. Each individual tax may not be absolutely just or equitable. The inequity of one tax may be neutralised by the equity of another. "There may be inequity in the parts but equity in the whole."

1. *'Principles of Political Economy'*, Book V, II, p. 2.

It is said that equity is a matter of opinion. There is no generally accepted definition of equity. It is, in the words of Dalton, "an elusive mistress whom perhaps it is only worth the while of philosophers to pursue ardently and of politicians to watch warily."

PROPORTIONAL *vs.* PROGRESSIVE TAXATION

In our discussion of the various theories of a fair distribution of the tax burden, we have almost invariably been led to the conclusion that there must be some degree of progression, wherever possible, in a tax.

Case for Proportional Taxation

There have been advocates of proportional taxation. McCulloch's well-known remark is typical of the attitude of the nineteenth century. He said: "When you abandon the plain principle (of proportion) you are at sea without rudder and compass and there is no amount of injustice you may not commit." J.S. Mill was even more emphatic. He said: "A graduated income-tax was an entirely unjust mode of taxation and, in fact, a graduated robbery." According to him, progressive taxation was a step towards confiscation.

Case Against

According to the principle of equality of sacrifice, proportional taxation could be justified only on the assumption that the marginal utility of income decreases slowly as income increases. But this assumption is not correct. If we keep in view the principle of proportional sacrifice, then the proportional tax can be justified only on the assumption that as income increases, the marginal utility of income does not at all decrease. This assumption is absurd, because when income increases, its marginal utility must decrease. Hence, proportional taxation can be justified neither on the principle of equality of sacrifice nor on the principle of proportional sacrifice.

Proportional taxation will entail equal sacrifice, whereas sacrifice itself should be proportional to the tax-payer's capacity. Proportional taxation is, therefore, not equitable. Further, it is also not sufficiently productive. Moreover, the element of arbitrariness even in proportional taxation is not altogether absent.

Hence, the theory of proportional taxation has been abandoned generally so far as direct taxation is concerned and, wherever possible, the principle of progressive taxation has been adopted instead.

Case for Progressive Taxation

The principle of progressive taxation is justified on the following grounds:—

(i) It is argued that as income increases, the utility of each addition to the income decreases. Hence, the payment of the tax by the rich entails much less sacrifice than by the poor. The rich people should, therefore, pay tax at high rates.

(ii) It is further argued that as income increases the expenditure on luxuries tends to increase, wher-as necessaries are more important than luxuries from the point of view of economic welfare. It follows, therefore, that by taxing the rich more, we only compel them to cut down luxuries. The sacrifice so entailed is not as great as the benefit to the poor on whom the tax proceeds may be spent.

(iii) Progressive taxation yields much greater revenue and hence it is more productive. It is very difficult to see how modern governments can balance their budgets today in the absence of the principle of progression.

(iv) Progressive taxation is more economical and equitable. The cost of collection of the taxes does not increase when the rate of the tax increases. About the equity of progressive taxation there can be no question. It calls forth a proportional sacrifice from the tax-payers. It places the heaviest burden on the broadest shoulders.

(v) The principle of progression gives to the tax system much-needed elasticity or flexibility. When there is an emergency, only a little raising of the rates may be sufficient to meet the situation.

(vi) The maintenance of law and order by the government benefits the rich much more than the poor. It enables the rich to make much more money. It is only proper, therefore, that they pay taxes at progressively higher rates.

(vii) Progressive taxation promotes economic stability and checks cyclical fluctuations. Progressive taxes mop up the purchasing power in the hands of the people. In this way, they ease inflationary pressures. In a deflationary situation, on the other hand, the amount of tax paid would fall as income falls and a much larger proportion of income may be left in the hands of the tax-payer to be spent. This would arrest the deflationary tendency. Hence, progressive taxes are contra-cyclical.

(viii) Progressive taxes are badly needed for reducing economic inequalities and for bringing about more equitable distribution of wealth in the community. It would curb the luxurious living of the rich which is resented by the poor, who cannot have even basic necessities of life.

(ix) Progressive taxes may increase the desire to work, save and invest on the part of the rich because they are keen to have the same sum after the tax as before the tax.

Case Against

The opponents of the progressive principle have raised several objections against the system. We examine below some of these objections:--

(i) It is said that it is all arbitrary. The degree of progression is settled by the finance minister on no definite and scientific basis. It is purely his personal opinion. Clearly, the objection is not to the principle but to the degree of progression. Although progression cannot be scientifically fixed, yet for practical purposes small differences do not matter. The members of the legislature are there to set right the angularities of the chancellor of the exchequer.

(ii) It is pointed out that the principle of progression cannot be advocated on the ground of promoting welfare, because welfare is subjective and cannot be measured. There is no scientific apparatus to test whether welfare has increased consequent on reduction of inequalities of income. The rich are perhaps vexed more than the poor are comforted.

(iii) Again, it is said that progression will discourage saving, drive out capital and thus hamper trade and industry. It will, in short, be uneconomical. But such dire consequences will follow only if the rate of progression exceeds the limits of reason and expediency. This has seldom been the case. Capital is not so sensitive as it is supposed to be.

(iv) The principle of progression is said to break down on scientific grounds. Its fundamental assumption that the same income measures the same satisfaction is not at all valid. Further, the law of diminishing marginal utility may not hold good in the case of money. "Money," they say, "does not represent one good, but goods in general; and since human wants in general are unlimited, it may be questioned whether the wealthy person does require the additional pounds less and less. It may even be that his desire for additional income increases as his income increases. Such may be the case when an increase in income causes the possessor to move into a higher social circle, and so bring about an extension in his necessary wants." [2]

But Robbins regards the use of the principle of diminishing marginal utility in this field as entirely illegitimate and unscientific. [3] Marginal utility being subjective cannot be ascertained by observation. As Robbins says, "There is no means of testing the magnitude of A's satisfaction as compared with B's . . . . Introspection does not enable A to measure what is going on in B's mind, nor B to measure what is going on in A's." In progressive taxation, we assume that persons with same income derive equal satisfaction therefrom. But we cannot prove that this assumption rests on ascertainable fact because satisfaction cannot be measured. "It would be rather silly," says Robbins, "if we continued to pretend that the justification of scheme of things was in any way scientific." Although on scientific grounds, the argument is unanswerable, but progression can be advocated equally strongly on ethical and political grounds.

(v) Investments which are risky but which yield rich harvest are discouraged because the proportion of tax increases as income increases. Reduction of investment will reduce the level of income and employment in the country.

(vi) Progressive taxes put premium on idleness and leisure since they penalise those who work hard and make more money. It amounts almost to graduated confiscation of rich man's income.

(vii) It is said that progression will lead to tax-evasion. But the possibility of evasion in proportional taxation is not less. It all depends on the social conscience.

Conclusion

Progressive taxation, whether it can be scientifically justified or not, is ethically sound, socially desirable and it conforms to the canons of equity, economy, productivity and elasticity. This principle has been universally adopted in all tax systems.

TAXABLE CAPACITY

The concept of taxable capacity has racked the brains of not a few economists and publicists. Dalton calls it "a dim and confused conception." He says, "Absolute taxable capacity is a myth and should be banished from all serious discussions on Public Finance." To the question whether taxable capacity can be measured, he thinks Cannan's 'No-how' is the best answer. Findlay Shirras, on the other hand, thinks that it is of great practical importance. "It is always wise and useful," he says, "for a government to know even roughly the limit that the country can contribute by way of taxation both in the ordinary and extraordinary circumstances." He goes on: "The necessity in post-war finance especially of balancing budgets heavily laden with public debt of short maturity, has made the question of absolute taxable capacity a real and an abiding problem of taxation." [4]

Meaning

The term taxable capacity can be used in two senses:

(i) in the absolute sense, and
(ii) in the relative sense.

The absolute taxable capacity has been variously defined. It means how much a particular community can pay in the form of taxes without producing unpleasant effects. Relative taxable capacity, on the other hand, means the respective contribution which the two communities should make towards a common expenditure, *e.g.*, provincial contribution to

2. Thomas, S.E.—*Elements of Economics*, 1936, p. 332.
3. Robbins, L.—*The Nature and Significance of Economic Science*, 1931, Ch. VI.
4. *Science of Public Finance*, 1936, p. 227.

Central expenditure. Dalton says the former is a myth and the latter a reality. The relative limit may be reached without reaching the absolute limit, *i.e.*, we may have reached the limit of how much a particular community should contribute without reaching the limit beyond which it possibly cannot contribute.

Absolute Taxable Capacity

There are two extreme views about absolute taxable capacity: (a) the capacity to pay without suffering, and (b) the capacity to pay regardless of suffering. In the former sense, taxable capacity is practically nil, for every tax must entail some suffering. In the latter case, there is practically no limit to taxable capacity except the one imposed by the extent of the resources of the community.

Sir Josiah Stamp defines taxable capacity as "the margin of total production over total consumption, or the amount required to maintain the population at subsistence level." This means the utmost that a community can pay "without having a really unhappy down-trodden existence and without dislocating the organisation too much."

Findlay Shirras defines absolute taxable capacity as "the maximum amount which the citizens of a country can contribute towards the expense of the public authorities, without having to undergo an unbearable strain. Briefly, taxable capacity is the limit of squeezability . . . . It is the taxation of a nation, the maximum amount of taxation that can be raised and spent to produce the maximum economic welfare in that community."

These definitions lack scientific precision and have an element of vagueness. Sir Stamp's "level of subsistence" and "unhappy downtrodden existence" and Shirras's "unbearable strain" and "maximum economic welfare" cannot be scientifically defined and laid down in exact terms. This, however, does not detract from the practical importance and the utility of the concept of taxable capacity. The meaning conveyed by the definitions given above is fairly clear, although we must admit that any attempt to measure the taxable capacity is foredoomed to failure. Cannan's 'No-how' is really the correct answer.

Limit of Taxable Capacity

Views also differ as to what are the symptoms to show that taxable capacity has been exceeded. Sir Stamp mentions two limits: (a) the check to total production, and (b) the check to total revenue yield. But the check may be due to causes other than excessive taxation. Taxation is not the only factor that affects production. Ellinger thinks that "the limits would be reached when so much is taken out of the tax-payers' pockets that the incentive to produce is reduced, and when insufficient remains to provide the necessary capital to make up for wastage and to set to work new workers in an increasing population." He obviously ignores the beneficent effect of public expenditure on production.

Factors Governing Taxable Capacity

The fact is that the taxable capacity is not rigidly fixed. It is a moving point. It is relative to so many factors that any change in any of them is bound to change our estimate about the taxable capacity of a nation. Findlay Shirras gives the following factors which determine the taxable capacity of a nation:

(i) **Number of Inhabitants.** It is quite obvious that the larger the population the greater is the taxable capacity of the community to contribute towards the expenses of the government. From this point of view, India is well placed. Its taxable capacity will infinitely increase when the country is economically developed.

(ii) **Distribution of Wealth.** If wealth is more equally distributed, the taxable capacity will be correspondingly reduced. But if there are large accumulations of wealth in a few hands, the government can raise more money by taxing the rich.

(iii) **Method of Taxation.** A scientifically constructed tax system with a wise admixture of the various types of taxes, direct and indirect, is sure to bring a larger yield. The Indian tax system is not much diversified; there are no taxes on large agricultural incomes. This certainly reduces the taxable capacity.

(iv) **Purpose of Taxation.** If the purpose of taxation is to promote welfare of the people they will be more willing to tax themselves. For a popular cause, the people will be willing to stretch their capacity to the utmost. If the government proceeds to raise money for fighting famine, disease or for spread of education, there will be a surprising expansion in the yield of taxes. But if the bulk of the public funds is to be spent on the maintenance of foreign armed forces and for the upkeep of a costly civil service, in which foreign element is predominant, as was the case in India, the taxable capacity must correspondingly shrink.

(v) **Psychology of Tax-payers.** Much depends on the people's attitude towards a government. A popular government can galvanise the spirit of the people and prepare them for a greater sacrifice. An appeal to patriotism is often the cause of the success of a financial measure. This is what makes war loans successful. Psychology of the people is an important factor, and unless they are properly approached, they may be unwilling to tax themselves.

(vi) **Stability of Income.** If the income of the citizens is precarious, there will be not much scope for further taxation. The vagaries of the monsoons in India account for a lower taxable capacity. It is only on stable incomes that long-term financial arrangements can be based.

(vii) **Inflation.** It lowers the purchasing power of the people and it cripples many; it has an adverse effect on taxable capacity.

(viii) **Level of Economic Development.** The level of economic development attained by a country is an important determinant of its taxable capacity. Undoubtedly, all highly developed countries of the world have greater taxable capacity than the under-developed countries.

(ix) Taxable capacity in a country also depends on political conditions prevailing at the time. Political stability relieves businessmen of all worries and uncertainty. It provides a congenial climate for the blossoming of variegated economic activity. On the other hand, political upheavals sap all business activity and hence adversely affect taxable capacity.

Conclusion

All these factors must be taken into account before we can have an idea about the taxable capacity of a nation. It may be that on account of the multiplicity of the factors influencing taxable capacity, we cannot measure this capacity. But this does not mean that the attempt is useless. The interest lies in the journey itself rather than in the destination. As Findlay Shirras puts it, "A road leading to an important centre has often many crossings, signposts, danger signals, but this does not lessen its value to the cautious sojourner."[5]

A Further Note on Case for Progressive Taxation

We have already discussed the case for and against progressive taxation. We would like to add a further note on the case for progressive taxation.

The terms 'proportional', 'progressive' and regressive refer to the relation between the tax rate and the tax base. But a sales tax is typically a proportional tax because the rate is the same whatever the tax base. It is, however, regressive when it is related to the buyer's income because rich and poor shall be paying at the same rate. Thus a tax may be proportional with regard to the tax base but regressive with respect to income.

The case for progressive taxation rests on the grounds of (a) revenue productivity, (b) optimum allocation of the tax burden, (c) promotion of stability and growth and (d) optimum allocation of resources.

For Revenue Productivity. The rising requirements of the State for providing social goods need a large revenue to meet them. The government cannot increase the rates of proportional taxation because that would press heavily on the poor. Obviously, the new rate increase must be concentrated on the rich people. Hence the only way to raise more revenue with less out-cry is to resort to progressive taxation.

For Optimum Allocation of Tax Burden. Marginal utility principle is helpful in this connection. It is as applicable to income as to goods. It is obvious that paying one additional rupee as tax from a large income is less burdensome than giving up a marginal rupee of a small income. In other words, if we want to equalise tax burdens, we should take a larger number of rupees from a large income than from a small income.

For Promoting Growth and Stability. A progressive tax has an automatic counter-cyclical effect. As income rises, marginal income pushes into higher brackets, raising both the marginal and average tax rates on these incomes. It is obvious that with progressive rates, taxes rise and fall more rapidly than income, whereas the proportional rates change the tax in proportion to income. Progression thus has the maximum counter-cyclical effect. It may also be noted that this effect is automatic and immediate and does not require any legislation. It may be clearly understood that this automatic reaction is not the result of progression in tax rates but because income is the tax base. Since individual income tax is progressive, it is regarded as an effective instrument reacting favourably, quickly and strongly in the interest of economic stability.

For Optimum Allocation of Resources. Progressive taxation can also be justified on the ground that it brings about optimum allocation of community's resources. Certain goods are considered preferable to others. It is therefore necessary that the community's resources should be allocated to the production of certain goods which are considered worth while rather than to others, which may be trivial or unimportant. Social judgement is substituted for individual preference in order to select goods which are preferable. It can be assumed that large incomes are more likely to be utilised in the satisfaction of trivial wants than small incomes. There is thus a case for heavier taxation of large incomes. In this way, progressive taxation can be used as an instrument for redistribution of income and resources in the community for achieving social objectives.

Conclusion. The diminishing marginal utility argument may not be very scientific but it is broadly correct. And the case for progressive taxation on the ground of revenue productivity, compensatory use and redistribution of community's resources is clear and strong. Nobody now seriously questions the validity and necessity of progressive taxation. If there is any difference of opinion, it is only about the degree of progression.

5. *Op. cit.*, 1936, p. 31.

64 INCIDENCE OF TAXATION

Meaning of Incidence

The problem of the incidence of a tax is the problem of who pays it. Taxes are not always borne by the people who pay them in the first instance. They are sometimes shifted on to other people. Incidence means the final resting place of a tax. Thus, incidence is on the man who ultimately bears the money burden of the tax.

New Concept of Incidence. To determine as to who bears the money burden of the tax is the conventional meaning of incidence. Some modern economists like Ursula Hicks and Musgrave have introduced a new concept of incidence. According to this new concept, incidence means the changes brought about in income distribution by changes in the budgetary policy, *i.e.,* changes both in taxes and public expenditure. The difference between the traditional concept and new concept may be carefully noted. In the conventional sense, incidence refers simply to the money burden of a tax but the new concept refers to distributional changes resulting both from taxation and public expenditure.

Impact and Incidence. We may distinguish between impact and incidence. The impact of a tax is on the person who pays it in the first instance and the incidence is on the one who finally bears it. If an excise duty is imposed on sugar, it is paid in the first instance by the sugar manufacturer; the impact is, therefore, on him. But the duty will be added to the price of the sugar sold, which, through a series of transfers, will ultimately fall on the consumer of sugar. The incidence is, therefore, on the final consumer.

Incidence and Effects. The term 'incidence' should be distinguished from the effects of taxation. The effect of a tax refers to incidental results of the tax. There are several consequences of the imposition of tax which are quite distinct from the problem of incidence. The imposition of an excise duty on sugar, we have seen, is shifted ultimately to the consumer of sugar. The incidence is on the consumer.

But the effects of this duty may be far-reaching; a heavy excise duty may cripple the industry. The manufacturer's profits will be reduced. Wages may be reduced. Labour and capital may have to leave the industry. Thousands of middlemen engaged in the distribution of sugar may find their earnings reduced. Reshuffling of their family budgets may affect the demand for certain other goods. The consumption of sugar may decrease and that of its substitutes may increase. All these are the effects of the tax. It is a much wider problem as distinguished from the incidence which is a narrow and a special problem of finding who bears the money burden of the tax.

Money Burden and Real Burden. We may also distinguish between the money burden of a tax and its real burden. The money burden of a tax is represented by the total amount of money received by the treasury. If a consumer has to spend Rs. 5 more per month on the sugar consumed by him on account of the levy of a duty on sugar, it is the money burden that he has to bear. But he may have reduced the consumption of sugar which may mean a reduction of his economic welfare. He may have to pinch in the consumption of some other commodities too. **This pinching, inconvenience, sacrifice, or, in short, loss of economic welfare is the real burden of the tax.** In incidence, we are concerned with the money burden and not the real burden.

Importance of Incidence

The study of incidence is very important. A tax system is not merely aimed at raising a certain amount of revenue, but the aim is to raise it from those sections of the people who can best bear the tax. The aim, in short, is to secure a just distribution of the tax burden. This obviously cannot be done unless an effort is made to trace the incidence of

each tax. We must know who pays it ultimately in order to find out whether it is just to ask him to pay it, or whether the burden imposed on him is according to the ability of the tax-payer or not. If the tax system is to conform to Adam Smith's first canon of taxation, *viz.*, the canon of equality, it becomes imperative to make a careful study of the reactions and repercussions of each tax and find out its final resting place.

There are certain taxes, called direct taxes, which are borne by the people who pay them first. The incidence in such cases is apparent. But the tax system of a country is not merely composed of direct taxes. There are indirect taxes also, whose reactions are a complicated affair. These taxes are intended to be shifted. But in actual practice, on account of economic friction, the shifting may not take place at all or it may be partial, or the tax may be shifted on to a class of people quite different from those intended to bear it.

If Public Finance is to serve as an instrument of social justice, the question of incidence at once assumes great importance. The rich have to be taxed and the proceeds have to be spent for the benefit of the poor. If we have to tax the rich, the incidence must be on the rich, otherwise the object is not served. We must, therefore, follow each tax and make sure that it finds a rich home to rest in.

Factors Determining Incidence

It would appear that the incidence of a tax or where its ultimate burden rests, depends on a number of factors. We give below some of them in a summary way:

(i) **Elasticity.** While considering incidence we consider both elasticity of demand and elasticity of supply. If the demand for the commodity taxed is elastic, the tax will tend to be shifted to the producer but, in case of inelastic demand, it will be largely borne by the consumer. In case of elastic supply, the burden will tend to be on the purchaser and in the case of inelastic supply on the producer.

(ii) **Price.** Since shifting of the tax burden can only take place through a change in price, price is a very important factor. If the tax leaves the price unchanged, the tax does not shift.

(iii) **Time.** In the short-run, the producer cannot make any adjustment in plant and equipment. If, therefore, demand falls on account of price rise resulting from the tax, he may not be able to reduce supply and may have to bear the tax to some extent through loss of profit resulting from a fall in demand. In the long period, however, full adjustment can be made and tax shifted to the consumer.

(iv) **Cost.** Tax raises the price; rise in price reduces demand and reduced demand results in the reduction of output. But a change in the scale of production affects cost and the effect will vary according as the industry is decreasing, increasing or constant costs industry. For instance, if the industry is subject to decreasing cost, a reduction in the scale of production will raise the cost and hence price, shifting the burden of the tax to the consumer.

(v) **Nature of the Tax.** A tax, for instance, on surplus or windfall will tend to remain where it is levied.

(vi) **Market Form.** Under perfect competition, no single producer or single purchaser can affect the price; hence shifting of the tax in either direction is out of the question. But under monopoly, a producer is in a position to influence price and hence shift the tax. Incidence of a tax on monopoly will be discussed in detail shortly.

DIRECT AND INDIRECT TAXES

Distinction Between the Direct Taxes and Indirect Taxes

We have said before that the question of incidence is very simple in the case of a direct tax, because the impact and the incidence are on the same person. But, in the case of an indirect tax, the impact is on one person and the incidence on another. A direct tax is not intended to be shifted, whereas an indirect tax is so intended. The question of incidence, therefore, really arises in the case of indirect taxes.

Taxes on commodities are generally called indirect taxes, for they are ultimately shifted completely or partially on to the consumers, whereas they are first collected from the dealers or producers. But we should remember that the mere fact that a tax is a commodity tax does not make it an indirect tax. A tax can be called an indirect tax, if its burden can be shifted and this happens when its price is affected by the tax. It is just possible that the commodity may be taxed, yet its price may remain unaffected. In this case, the consumer is not touched, and the tax will be called direct and not indirect, even though it is a tax on a commodity.

A lump-sum tax imposed on a monopolist or as a percentage of monopoly net revenue is not shifted, while a monopoly tax in proportion to the output tends to be shifted. In the former case, it will be a direct tax, and in the latter it will be indirect. The inheritance tax is commonly considered a direct tax. It falls on the successor and it tends to stay there. But the predecessor, while he was alive, may have taken an insurance policy to cover the amount of the tax. In this case, it imposes an indirect money burden on him. Income-tax, again, is a direct tax but in exceptional cases a part of it may be shifted. To that extent it will become an indirect tax.

We may thus conclude by saying that we cannot draw hard and fast lines between taxes which are direct and those which are indirect. The distinction between the two types is settled by the question

whether the tax has been shifted or not. If it is shifted, it is indirect, otherwise direct.

Relative Merits and Demerits of Direct and Indirect Taxes

We compare these two forms of taxes not with the object of choosing whether we should have the one or the other. No country relies exclusively on one type. Both direct and indirect taxes are needed to make up an equitable and adequate tax system. "I can never think," said the great Scotsman, "of direct and indirect taxation except as I should think of two attractive sisters who have been introduced into the gay world of London, each with an ample fortune, both having the same parentage—for the parents of both I believe to be Necessity and Invention—differing only as sisters may differ . . . ." However, direct taxes are better in some respects and indirect taxes in some other respects.

Merits of Direct Taxes

The following merits are claimed for direct taxes:—

(i) **Equitable.** Direct taxes are more equitable as progression can be applied to them. The rate of the tax is varied to make the tax conform to the ability to pay.

(ii) **Economical.** They are economical as the cost of collection is small. There being no intermediary between the tax-payer and the State, no part of the tax evaporates in transit.

(iii) **Certain.** The yield of direct taxes can be calculated with a fair degree of precision. The tax-payer is also certain of the amount that he has to pay.

(iv) **Elastic.** Direct taxes have a high degree of elasticity. Income-tax has remarkably responded to the enormously enhanced needs of the State of defence and development.

(v) **Civic Consciousness.** They create a civic consciousness among the tax-payers. A man who pays a direct tax feels that he is contributing towards the State expenditure. He is expected to take keener interest in civic affairs.

(vi) **Reduction of Inequalities.** Progressive taxes are used as an instrument for the reduction of economic inequalities. The rich persons are called upon to pay taxes at a higher rate so that the gulf between the rich and the poor is narrowed down. However, economic inequalities cannot be reduced by taxes alone. Public expenditure should also be so directed as to benefit the poor more than the rich.

Demerits

The following are the chief demerits of direct taxes:—

(i) **Inconvenient.** Direct taxes are very inconvenient to pay. Every tax-payer feels the pinch. The tax has to be paid in a lump sum; the filling of returns is a complicated affair; and there is a lot of harassment.

(ii) **Unpopular.** Direct taxes are very unpopular. Nobody likes to pay them. To part with money is not an easy thing, especially when there is no direct quid pro quo.

(iii) **Evasion.** They can be easily evaded and the State defrauded of its due. That is why, it is said that a direct tax is a tax on honesty.

(iv) **Arbitrary.** The direct taxes are arbitrary in the sense that the rates of taxes are fixed arbitrarily by the government. The rate could as well be different. The rates are not determined on any scientific principle. A leftist government will fix higher rates and a rightist government lower rates. It is all arbitrary.

Merits of Indirect Taxation

Some advantages of indirect taxes are given below:—

(i) **Convenient.** An indirect tax is convenient. We pay the tax when we buy a commodity, and at a time when we can afford it. It is paid in small trickles rather than in a lump sum. 'Many people prefer to be taxed in the dark.' The tax-payer does not feel that he is paying it. The tax is wrapped in the price of the commodity he buys.

(ii) **No Evasion.** It is very difficult to evade an indirect tax, because it is mixed up with the price of the commodity one purchases.

(iii) **Equitable.** Indirect taxes can also be made more equitable by being imposed on articles generally consumed by the rich. That is why luxuries are generally taxed at a higher rate.

(iv) **Elastic.** When imposed on necessaries of life or articles for which the demand is inelastic, indirect taxes are also fairly elastic. They can, therefore, be varied according to the State needs.

(v) **Beneficial Social Effects.** Indirect taxes have a beneficial social effect in that the consumption of harmful drugs and intoxicants can be discouraged by means of such taxes.

(vi) **Capital Formation.** Indirect taxes are levied on the consumption of commodities. In this way, consumption is reduced. The savings so made can be invested in some productive employment.

(vii) **Re-allocation of Resources.** Taxation of some commodities will discourage their production. The resources used in their production may be utilised in the production of more desirable commodities. In this way, resources devoted to the production of luxuries can be diverted to the production of goods required by the masses.

(viii) **Wide Coverage.** Indirect taxes can be levied on a large number of commodities. In this way, larger sections of consuming public can be made to

contribute to the public exchequer. In India, the tax net of central excise duties is being spread wider and wider.

(ix) **Productive.** Since they can be given a wide coverage, indirect taxes can be very productive. It is the Indian experience that Union excise duties and sales tax have yielded a very substantial revenue and have become the mainstay of the respective governments.

(x) **Reduce Disincentiveness of Direct Taxation.** Since indirect taxes have proved very productive of revenue, it has obviated the necessity of steeply progressive direct taxation which would have been very disincentive of saving and investment.

Demerits

The following are some of the disadvantages of indirect taxes:—

(i) **Uncertain.** Indirect taxes are uncertain. It is not always possible to anticipate the various repercussions of a tax imposed on a commodity. A finance minister cannot precisely calculate the estimated yield of a tax.

(ii) **Regressive.** They are regressive. Every consumer of the taxed commodity, rich or poor, pays the tax at the same rate. Therefore, the real burden of the tax on the poor is greater than on the rich. If the tax is imposed on the necessaries of life, its regressive character is accentuated. According to Engel's Law of Consumption, the bulk of a poor man's income is spent on necessaries of life. The poor man pays the tax, therefore, on almost all his income, while the rich man pays it on a relatively smaller portion of the income spent on necessaries of life.

(iii) **No Civic Consciousness.** Indirect taxes do not develop any civic consciousness in the tax-payer, because nobody feels that he is paying a tax as it is concealed in price.

(iv) **Uneconomical.** Although the shopkeeper is considered an unpaid tax collector, yet it is thought that the cost of collection of certain indirect taxes is very heavy. In the case of customs duties, a highly-paid staff of customs officials, appraisers, raiding parties to prevent smuggling have to be engaged. These taxes are uneconomical in another way as well. The taxed commodity passes through a number of middlemen and each middleman adds something to the tax, so that the final consumer pays much more than what the State receives.

(v) **Inflationary.** The indirect taxes have one serious danger especially in developing countries, *viz.*, they contribute to the inflationary pressures in the economy. Every tax levied on a commodity must inevitably raise its price and if prices are already rising, it feeds inflation.

(vi) **Evasion.** Certain of the indirect taxes are easily evaded. For example, excise duty on manufactured goods are collected at the factory gate when the goods roll out. But one cannot be sure that all goods going out actually pay the duty for there may be leakages. Similarly, if a tax is levied on the farm products, the portion consumed by the grower escapes taxation.

(vii) **Loss of Economic Welfare.** Taxation on commodities raises their price. But in case of goods produced under the conditions of the law of increasing returns (or decreasing cost), the price rises more than the cost. In this case, the consumers suffer and the community suffers a loss of economic welfare.

Conclusion. The distinction between direct taxes and indirect taxes is not of much practical importance. We cannot assume that the entire burden of direct taxation falls on the rich and that of indirect taxation on the poor. Indirect taxes, like taxes on luxuries, fall on the rich and not on the poor. It is, however, generally true that direct taxes like inheritance tax and income-tax and super-tax fall exclusively on the rich. In a good tax system, we must have a proper balance between direct and indirect taxation. One corrects the other. Indirect taxation relieves exclusive pressure on the rich and makes the system of taxation broad-based. Thus, the two taxes are complementary. A good tax system has a goodly proportion of both types.

ROLE OF INDIRECT TAXATION IN A DEVELOPING ECONOMY

Indirect taxes have to play a very important role in a developing economy. This is due to the fact that owing to general poverty and low level of G.N.P. or low individual incomes, the scope for direct taxes is limited or their yield is comparatively very low. For instance, in India wealth tax, death duties, gift tax, *etc.*, do not yield much. Hence, greater and greater reliance has to be placed on indirect taxes. No wonder that range of Union excise duties in India is becoming wider and wider every year. Indirect taxation has proved to be a very potent weapon of resource mobilisation. They raise the rate of investment by curtailing consumption and raising the incremental ratio of saving.

The developing countries have to rely more on indirect taxes for the following main reasons: In the first place, low levels of income in the underdeveloped countries provide only a limited scope for direct taxation, *e.g.*, income tax and wealth tax. The tax net can be spread much wider through commodity taxation. Even commodities of universal consumption can be taxed to raise adequate revenues.

Secondly, Indirect taxation is specially important from the point of view of economic growth on which such countries have set their heart. To accelerate economic growth, the rates of saving and investment must be raised sufficiently. This cannot be done without curtailing consumption and in these coun-

tries propensity to consume is notoriously high. Duesenberry's 'Demonstration Effect' operates very sharply. To tax commodities is the only effective way of putting curbs on consumption and release funds for productive investment.

Thirdly, Indirect taxation also transfers the growing agricultural surplus from the rural to the urban areas by taxing the farm sector and by cheking, consumption on the part of the newly prosperous farmers.

In the words of Taxation Enquiry Commission, "For any substantial receipts from commodity taxation and appreciable restraints on consumption in the economy as a whole, it will be necessary to extend excise and sales taxation to the consumption of lower income groups and of goods which are commonly classed as necessaries."[1]

The basic objective is to raise resources for public investment and indirect taxes play a significant role in bringing about diversion of resources from consumption to production and from private sector to the public sector. By means of taxation, the government acquires purchasing power from the people and then uses the funds so raised in productive investment which is essential for rapid economic growth.

INCIDENCE OF SOME TAXES

Incidence of Taxes on Personal Income

Income-tax, super-tax, excess profits tax are all direct taxes and are as such borne by the people who pay them in the first instance. They cannot ordinarily be shifted. But a businessman, who is in an exceptionally strong position relative to the persons he deals with, may be able to shift a part of the tax to his customers. May be that he is the seller of a very popular brand; may be that he is a very popular doctor in whom his patients have implicit faith. In such cases, the patients may be willing to pay a bit more. But these conditions are rarely present, and the income-tax payers must ordinarily bear the burden of the tax. A tax on the businessman's income has no influence on price which is determined by demand and supply.

Businessman's income depends on his profits. Profit depends on price, and not vice versa. A tax on profit, therefore, cannot be passed on to the consumer by raising the price. In the long run, however, a heavy tax may check enterprise by reducing the anticipated profits. But it will depend on elasticity of supply and alternative channels of investment available. It is very difficult to say what will happen in the long run. The probability is that a moderate tax will not have any undesirable repercussions.

If, however, the income-tax is extremely heavy, it may discourage saving, check accumulation of capital or drive it abroad. The productive capacity of the community will thus be impaired and there will be widespread repercussions of such a heavy tax. But the tax is seldom so heavy. Ordinarily, therefore, it rests on those on whom it is imposed.

A heavy income-tax may discourage incentive and enterprise. This, however, will depend on whether the tax falls on average income or marginal income. In the former case, the tax-payer is transferred to a lower income group and he must work harder to maintain his customary standard of living. If the increase in tax falls mainly on the marginal income, it will mean a positive discouragement to the earning of that income. How far actually the enterprise will be affected will depend on the tax-payer's ability to vary his income and hence, his liability to be taxed, by varying his effort. Ordinarily, few workers have the ability to vary their income by varying their effort; only, when there is a great demand for overtime, they may be able to do so.

Incidence of Corporation Tax

It is a tax on companies. It is imposed on the net profit of the corporations or joint stock companies. By reducing the funds available for re-investment, the corporation tax militates against expansion and development.

Also, the amount available to be distributed as dividends is reduced. This also serves as a disincentive to the investing public. Capital formation is checked thereby. Thus, flow of equity capital is checked. The prices of the goods manufactured by such corporations rise which may give place to cheaper substitutes resulting in a shift of resources in their favour.

Further, since corporation taxes discourage investment, the level of national income and employment is reduced. If, however, the corporation which is taxed, maintains the dividend rate by paying dividend out of the undistributed profits, then neither is consumption reduced nor the flow of equity capital checked.

A corporation tax, by reducing the earnings of the existing firms, discourages the entry of new firms into the industry which may result in a monopoly or a semi-monopoly for the existing firms with all the attendant evils.

Further, its disincentive effect may lower efficiency. A part of the corporation tax may be shifted to the buyers through a price rise.

Incidence of Tax on Profits

The problem of incidence of tax on profits is complicated by the fact that there is difference of opinion among the economists about the definition of profits and the elements that compose it. Some

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1. *Report*, Vol. I, p. 149.

economists, like Prof. Walker, regard profits as analogous to rent. In this sense, profit is a surplus earned by the entrepreneur superior to the marginal entrepreneur. The price in the market is determined by the marginal producer. Hence, profits, like rent, do not enter into price. It cannot, therefore, be shifted to the consumer. It will be borne by the businessman who pays it. This is Walker's view.

But we do not subscribe to this view. Even the marginal entrepreneur must have profit in the long run. Normal profit is, therefore, not a surplus but a part of the necessary cost. This, however, does not lead us to the conclusion that a tax on profit will be shifted to the consumer, unless the entrepreneur is able to influence the price which he rarely can. For an individual entrepreneur, price in the market is fixed. This being so, a tax on his profits must come out of his own pocket. A general tax on profits, as a rule, is not shifted unless the prices are rising rapidly and the consumers are anxious to buy. This, however, is very rare.

But if the tax is a special one on profits from a particular trade and industry, there will be a tendency on the part of the entrepreneurs to withdraw themselves from such lines. If this happens, the incidence will ultimately be shifted to the consumers of the commodity or the users of the service supplied by the entrepreneurs. A great deal depends upon the elasticity of demand and the mobility of capital.

A tax on profits may take the form of a licence duty. Even this will be borne by the producer. In order to reimburse himself, the producer may increase his output. The consumer benefits but the incidence of licence duty will remain on the producer. It is generally too small to make the producer try to shift it.

Although complete exemption of profits from taxation is not desirable, yet a high tax is highly undesirable. It will put a brake on invention and enterprise and it will cut down revenues and thus hinder modernisation of plant. In the words of Mrs. Hicks, "The effect of an additional tax on profits on a curve of expected returns is to shift the curve bodily to the left, but without altering its shape or the chance of loss. The chance of very high gains which formerly balanced the big chance of loss in the risky investment curve is thus cut off, and the scales are consequently tipped against it; while the safe investment, being relatively unaffected, will become the more attractive.

"The discrimination of high profits tax against 'venture capital' is serious for any country that means to keep abreast of modern development; it is perhaps especially serious in an established industrial country well supplied with most sorts of industrial equipment, and where, consequently, new enterprise needs to be especially on the alert. This tax has also important cyclical relevance; in depression, curves of expected returns flatten out; many normally safe investments pass into the risky class".

Effects of Wealth Tax

Wealth tax is imposed on value of a person's stock of wealth at a point of time, say at the end of financial year. The wealth tax does not discriminate against risky investment. In this way, it promotes economic development. By enabling the government not to raise the income tax rates too high, the wealth tax encourages investment in modern industries. Another obvious effect of wealth tax is the reduction of economic inequalities by reducing the size of the inherited wealth. The tax is borne by the persons on whom it is levied. It reduces the size of unearned income. The wealth tax discourages productive investment. It influences the supply of money capital. It encourages consumption and discourages saving or capital formation. The tendency to purchase non-durable goods will increase.

Incidence of Property Tax

The distinction between wealth tax and property tax may be clearly understood. The wealth tax is imposed on the net wealth of the individual. In calculating the net wealth outstanding claims of others are deducted from the gross value of the assets. But the property tax is levied on the gross value of the property irrespective of the ownership and no deduction is allowed for the outstanding claims of others against the property.

Property includes real estate like lands and buildings, machinery, inventories, household effects. jewellery, bank balances, bonds, *etc.* In actual practice, only the real estate like land and buildings are taxed.

In case of property used for consumption, (*e.g.*, jewellery, house and household effects), there is no shifting of the tax and the incidence is on the person on whom the tax is levied. But when the property is used for production, the producers will attempt to shift it to the consumers. But much depends on the elasticity of demand and supply.

We shall, therefore, consider now incidence of land taxation and tax on buildings.

Incidence of Land Taxation

The value of land depends on two sets of factors: (a) Natural factors like the fertility of the soil, the situation of the land, some other natural conditions; and (b) investment of capital in drainage schemes, anti-erosion measures, irrigation facilities and other measures necessary to increase and sustain productivity.

The tax depending on the first set of factors is a tax on economic rent and has a tendency to fall on the owners. The landlord cannot shift it to the tenant, for economic rent is determined by factors

independent of a land tax. The owner is supposed already to be charging rent fully measuring the superiority of his land over the marginal land. But in case, through ignorance, indifference or indulgence, he has not been charging full economic rent, he will, when the tax is imposed, sharply look round and take in the 'slack'. To this extent, the tax is shifted to the tenant.

Tax of this nature, *i.e.*, the tax on economic rent, cannot be passed on to the consumer, for the consumer can only be reached through the price. We know that economic rent does not enter into price. The raising or lowering of the rent does not affect price. The fact that the tax is paid by the occupier makes no difference. If he pays it in the first instance, he can deduct it when he pays the rent to the owner.

Thus, tax on economic rent is borne by the owner of the land and not by the tenant or the consumer of the product.

But, where the owner can vary his investment in land, he will reduce this investment when the tax is imposed. This will affect the yield and hence the price of the commodity. In this case, *i.e.*, in the case of improvements, it is shifted to the consumer.

Tax on building sites also tends to be thrown on those owners of sites who enjoy surplus income on account of more favourable situation of their sites.

Can the land tax be shifted to a prospective purchaser of the land? No, the tendency is that it will be borne by the present owner. The purchaser, while purchasing land, will bear in mind that he will have to pay the tax. He will, consequently, offer less price. The tax is thus capitalised or absorbed in the lower price that the land will command. This will happen to the extent that future tax payments can be accurately forecast. But there is also a neutralising tendency. Future increases in land values may also be anticipated and more price offered.

Incidence of Tax on Buildings

There are two parties in immediate contact with each other so far as housing is concerned, *viz.*, the owner and the occupier. If the tax is imposed on the owner, he will try to raise the house rent and thus shift the tax to the occupier or the tenant. But he cannot do this during the currency of the lease. Further, there may be a rent law controlling rent and forbidding the landlord from raising the rent. Even if he can raise the rent, the tenant may shift to some other house preferring smaller accommodation to paying a higher rent. In such cases, therefore, the incidence will be on the landlord, at any rate, for some time.

But the effect will be that building houses for letting out may not remain a paying proposition. A heavy tax will check building activity and the remuneration of the builder and of other people engaged in the trade may fall. The demand for building sites may decrease. If they try to sell off, the new purchaser will bear in mind the tax, and offer correspondingly less. But, in course of time, the supply of houses will fall off and the rents must rise thus shifting the burden, to some extent, to the tenants. Thus, the tax may fall partly on the owner, partly on the builder and partly on the occupier.

If, on the other hand, the tax is imposed on the occupier, it will tend to stick to him. It is not easy to find a new house nor so convenient to shift. One likes to stay on, where one is. The demand for a house is inelastic. The landlord, therefore, is in a much stronger position. The tax will, thus, stay where its first impact is. But if the occupier is a shopkeeper, he may be able to shift the tax to his customers in the neighbourhood by raising a bit the prices of the commodities he sells. We must remember, however, that the development of the means of communication and transport brings the travelling salesman to our very door and weakens the grip of the neighbouring store.

We shall, thus, conclude that the tax on buildings will fall generally on the occupier but under certain circumstances may be shifted to the owner, the builder or the customer.

Incidence of Death Duty

In almost all advanced countries, death duties form an important part of the tax system. Death duties take two forms: Estate Duty and Succession Duty. The estate duty is levied on the total value of the estate (*i.e.*, movable and immovable property) left by the deceased irrespective of the relationship of the successor. It is graduated with reference to the total value of the property. The succession duty varies with the relationship of the beneficiary to the deceased. It is graduated on the basis of the windfall element which increases with the distance of relationship. Further, it takes into consideration individual share of the successor and not the total value as in estate duty.

Death duties are justified on the ground that the government is said to be a silent partner in the creation of wealth. It is aimed at reducing inequalities of wealth and concentration of economic power in the hands of a few persons. By reducing unearned income from wealth, this tax makes for equality of opportunity. But the death duties may reduce savings by discouraging savings to avoid a heavy death duty. This tax also reduces the ability to save on the part of the heirs. Thus, capital formation is adversely affected.

The death duty tends to disrupt small enterprises because they are forced to sell themselves to larger firms in order to pay the tax. This promotes the growth of monopolies. By encouraging the formation of trusts in order to avoid substantial tax

liabilities, the death duties favour conservative investment policies.

The willingness to work may be affected by death duties. If a person wants to leave to his heirs assets of certain size after the payment of tax he may have to work harder. On the other hand, if the marginal rate of tax rises with every increase in his estate he will tend to work less. It is possible that the rich people may dissipate their wealth during their lives. But if they have greater concern for their heirs, they may consume less and save more. If, however, the marginal tax rate is very high, it may encourage consumption and discourage saving.

The transfer of property at death may disrupt small business which may not be in the interest of the community. By reducing the successors' amount of wealth, death duty will decrease their consumption and investment and adversely affect the level of income and employment.

Where is the incidence of death duties? Is the incidence on the deceased or the beneficiary, *i.e.*, the successor? The owner is dead and it is said that death pays all debts. He can be taxed no more. No further burden can be placed on him. If, however, he had got insured to pay such a tax, he certainly bore it when he paid the insurance premium. In the absence of any such anticipation by the owner of the property, when he was alive, the tax will obviously fall on the beneficiary.

Incidence of Tax on Monopoly

The question of incidence is a part of the larger question of the theory of value. As value determination differs in the case of monopoly from the value determination under competitive conditions, the incidence of a tax on monopoly works out differently.

The monopoly tax may be (a) independent of the output of the monopolised product; or (b) it may vary with the output, *i.e.*, increase or decrease with the output.

(a) When the tax is independent of the quantity produced, it may either be lump-sum tax on the monopolist or a percentage of the monopoly net revenue (profit). In both these cases, it will fall on the monopolist. He cannot shift it to the consumer. This could be done by raising the price. But he is already supposed to have fixed a price which yielded him the maximum monopoly net revenue. If it had been possible for him to raise the price consistent with the policy of maximising his profit, he would have done it already. Any alteration in the price, thus, would be at the expense of his profit. That being the case, he must now pay the tax out of his own profit. He will get maximum profit now after paying the tax by leaving the selling price unchanged and the consumer unaffected.

It is possible that, instead of re-calculating how he would maximise his profit after paying the tax, he may simply put up the price shifting the tax to the consumer. But by so doing he may have reduced his monopoly profit. "He may prefer this to a rather greater profit at the expense of a greater effort."

In case, however, he has been charging less out of consideration for consumers' welfare than what he could charge for maximising his profit, he will, when the tax is imposed, take in the 'slack'. To this extent, the burden of the tax will be shifted to the consumers.

(b) Now let us see what happens when the tax varies directly or inversely with the quantity of the commodity produced. In this case, as discussed in the previous section, elasticities of demand and supply and the influence of the laws of returns will have to be taken into account. The tax will enter into the cost of production. It will mean an addition to the cost of each unit produced. Taxing of the commodity, therefore, raises the price which will tend to reduce the demand.

If, however, the demand is inelastic, it cannot be appreciably reduced and the tax will be borne by the consumer. If the demand is elastic, the consumers may buy less when the tax has raised the price. In this case, the tax will partly be borne by the monopolist. Instead of facing a decline in demand, the monopolist may reduce the price and decide to bear the tax himself. If the supply is more elastic, then the producer is in a stronger position. Thus, if the demand is more elastic than the supply, the consumer will bear less burden of the tax; and if the supply is more elastic than the demand, then the producer will bear less.

If the production of the commodity obeys the law of increasing returns, the reduction in output, consequent upon the imposition of a tax, will raise the price more than if it were subject to the law of diminishing returns. The burden on the consumer in the former case will be greater than in the latter case. When the marginal costs are constant and the demand curve facing the monopolist is a straight line, then, according to the theory of monopoly price, the price of the taxed commodity will be raised by half the amount of the tax: under competition it would have risen by the full amount of the tax.

In case the demand curve is concave, the rise in price will be greater than this. Were the demand curve is so concave as to make the marginal revenue curve parallel to the demand curve over the relevant range, the price will be raised by the full amount of the tax. In cases, however, the demand curve is not only concave but indicates constant elasticity. the ratio between price and marginal cost will be constant. The marginal revenue being necessarily less than price, the slope of the marginal revenue curve will be less than that of the demand curve so that the price will rise by more than the tax.

If in order to stimulate production, the rate of the tax varies inversely with the output, then the monopolist will be tempted to produce more and keep the price low. The burden of the tax will thus be entirely on the monopolist who will, in fact, be transferring a part of his monopoly profit to the consumers.

The fact is that, owing to the exceptional ability of the monopolists to manipulate the price and control the market, the incidence of a monopoly tax is uncertain.

Incidence of a Commodity Tax

Taxes on commodities may take different forms: (a) a tax on manufacture or production of a commodity called excise duties, (b) a tax on sale of a particular commodity or general sales tax, and (c) import or export of commodity known as customs duty.

A tax on a commodity tends to be shifted from the producer forward to the consumer and from the consumer backward to the producer. A tax on production of a commodity tends to raise its price and will, therefore, be normally borne by the consumer. But a tax on consumption is likely to check consumption and tends to be shifted backward to the producer.

The extent to which a commodity tax will actually be shifted will depend upon the nature of demand and supply curves. If demand is inelastic, as is the case with the necessaries of life, the people must buy the commodity. The producer will be in a stronger position and almost the entire burden of the tax will be shifted on to the consumer. But in the case of elastic demand, the people will buy less. In that case, the price will not rise by the full amount of the tax, and the tax will be partly borne by the producer.

The tax on a commodity will, therefore, be borne partly by the buyers and partly by the sellers. How much exactly? It will depend on the degree of elasticity of demand or supply. In the same manner, if the supply is inelastic, as in the case of a perishable commodity, the seller cannot withdraw the supply. His position is weak. The tax will stick to him. In the case of elastic supply, he can shift the burden on to the consumers. "As a rule, the consumer bears a smaller part of the tax when the demand is more elastic than the supply than he does when the supply is more elastic than the demand."

It is possible that the price may not rise at all. This will happen when the consumers have been able to discover an untaxed supply of the commodity or a satisfactory untaxed substitute. In this case, the entire burden of the tax will fall on the producer or the seller.

On the supply side, the laws of returns will also exert their influence. The taxing of a commodity tends to check its demand which, in its turn, will check production. Now if the industry is subject to the law of increasing returns, the reduced production will be obtained at a higher cost and, in the case of the law of diminishing returns, at a lower cost. In the former case, the price will be higher than in the latter with a corresponding burden on the consumer.

Much also depends on the amount and the method of taxation. Nobody bothers about a small tax. No producer would like to annoy his customers for a paltry sum. He would cheerfully bear it himself. Only when the tax is heavy will the shifting take place. A tax on marginal output will raise the price and not the one on the surplus output.

The nature of the commodity also will make a difference. A tax on a commodity like sugar gets rapidly adjusted and shifted. But a tax on a house cannot be so readily shifted for rent is fixed for a period and during the currency of the lease no change can be made.

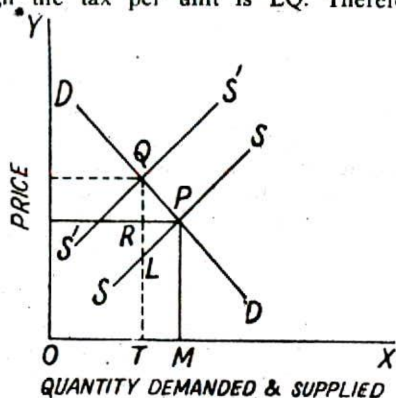
Other factors which govern the course of shifting of a commodity tax are whether competition is perfect, and whether labour and capital are freely mobile. Only in case of free and unfettered competition can the tax be passed on to the consumer, otherwise it will stick to the producer. If labour and capital are freely mobile, it will add to the ability of the producer to shift the burden on to the consumer. If, on the other hand, large fixed capital is locked up in the industry, the position of the producer is correspondingly weakened, and the probability is that the tax burden will be borne by him. He cannot withdraw his capital. He must continue in the field even though he may be losing for a time.

Since the demand for a taxed commodity is reduced, productive resources may be shifted from the taxed to the non-taxed industries. Thus, the investment pattern will change to the disadvantage of the consumer. Hence, economic welfare is reduced. Also, economic inequalities are accentuated because commodity taxes are regressive, unless they are imposed on undesirable or injurious products.

Diagrammatic Representation. How the burden of a commodity tax is distributed between the buyers and sellers or producers according to ratio of elasticities of demand and supply is shown in the following diagram on the next page (Fig. 64.1):

In this diagram, DD is the demand curve and SS is the supply curve. They intersect at P and MP is the price determined. Now suppose a sales tax per unit of the commodity has been levied. As a result, its supply curve will rise upward equal to the tax per unit, because the tax will be added to the supply price. The new supply curve will be S'S'. The distance between the two supply curves represents the tax per unit of the commodity. The new supply curve S'S' cuts the demand curve at Q and, therefore, now TQ is the price determined which is higher than the old price PM by RQ. Hence, RQ is

the burden of the tax borne by the consumer even though the tax per unit is LQ. Therefore, RL



Incidence of Commodity Taxes
Fig. 64.1

(LQ−QR) is the burden of the tax borne by the seller or he has RL price less than before (PM being the first price).

We can show that the splitting of the burden of the tax LQ into RL on the seller and RQ on the buyer is equal to the ratio of elasticities of demand and supply thus:

$$\frac{RL}{RQ} = \frac{\text{Burden of the Tax on the seller (producer)}}{\text{Burden of the Tax on the buyer (consumer)}}$$

Elasticity of Demand

$$= \frac{\text{Proportionate decrease in the quantity demanded}}{\text{Proportionate increase in price}}$$

$$= \frac{MT}{OM} \div \frac{RQ}{MP}$$

$$= \frac{MT}{OM} \times \frac{MP}{RQ} \qquad \ldots(1)$$

Elasticity of Supply

$$= \frac{\text{Proportionate decrease in the quantity supplied}}{\text{Proportionate decrease in price}}$$

$$= \frac{MT}{OM} \div \frac{RL}{MP}$$

$$= \frac{MT}{OM} \times \frac{MP}{RL} \qquad \ldots(2)$$

$$\frac{\text{Elasticity of Demand}}{\text{Elasticity of Suppy}} = \frac{\frac{MT}{OM} \times \frac{MP}{RQ} \quad \text{.........No. (1) above}}{\frac{MT}{OM} \times \frac{MP}{RL} \quad \text{.........No. (2) above}}$$

$$= \frac{\frac{MP}{RQ}}{\frac{MP}{RL}} = \frac{MP}{RQ} \times \frac{RL}{MP}$$

$$= \frac{RL}{RQ}$$

We have seen above that RL is the burden of the tax on the seller and RQ is the burden of the tax on the buyer or consumer.

$$\text{Hence} \quad \frac{RL}{RQ} = \frac{\text{Burden of the tax on the seller}}{\text{Burden of the tax on the consumer}} = \frac{\text{Elasticity of Demand}}{\text{Elasticity of supply}}$$

It is clear that the limits within which a commodity tax is shared between the buyers and sellers depends on the elasticities of demand and supply. If the demand is inelastic, as is the case with the necessaries of life, the people must buy them whatever the increase in the price as a result of imposition of a tax. In such a situation, the seller's position is stronger and the entire burden of the tax will be shifted to the consumer. But if the demand is elastic, it will contract when the price rises. Hence, price will not rise to the full amount of the tax. Therefore, a part of the tax will be borne by the sellers or producers and a part by the buyers or consumers. But exactly how much? This will depend on the ratio of elasticity of demand and elasticity of supply. In the same manner, if the supply is inelastic as is the case with perishable commodities, the sellers cannot reduce the supply as price rises and their position is weaker. In such a situation, the burden of the tax will be on the sellers or producers —and it cannot be shifted to the purchasers or consumers. On the contrary, if the supply is elastic, then the sellers can withdraw the supply if the price does not suit them. In such a situation, the burden of the tax will be on the buyers or consumers.

Conclusion. Thus, incidence of a commodity tax is a very complicated affair. It is a part of a large problem of price determination. There are various conflicting influences on price. We say that generally a tax on a commodity tends to be borne by the consumer. But this tendency may or may not be actually realised. Unless the price is affected, the consumer is not touched and he is touched only to the extent that the price is raised by the imposition of the tax.

Incidence of Sales Tax

The sales tax is levied on the turnover, profits or no profits. Its incidence is a complicated affair, because it covers commodities of widely divergent nature. If the demand for a commodity is inelastic, its price can be raised and the tax will be then shifted to the consumer to that extent. But if the demand is elastic, it may be shifted partly to the consumer and may remain partly on the seller. If the supply is perfectly elastic, the entire burden of the tax will fall upon the buyer and if the supply is perfectly inelastic, the entire burden will be on the seller. If the supply is only relatively elastic or inelastic then the tax burden will be shared between the buyer and the seller.

There are possibilities of incidence shifting forward (to the buyers) and backward (to the seller or factors of production) in the long run. For instance, if the demand falls, the output will be reduced and demand for factors may go down reducing their reward.

The sales tax may make heavy inroads into profits which may lead to retrenchment in staff and management, restrict enterprise and employment leaving some business premises unoccupied. Thus, its incidence may fall upon the employees, management and landlords. Sales tax indeed hits a large number of people of different types.

Incidence of Import and Export Duties

Import duties are generally, and almost exclusively, borne by the home consumer. The duty paid by the importer is added to the price that he charges from the next buyer, and so on. The duty is ultimately shifted to the consumer. Only, in very rare case, the burden of such duties may be shifted to the foreign producer. If, for instance, our demand for the imported product is elastic so that we may or may not buy it, and the supply is inelastic and the foreign producer has no alternative market, then in such a case the burden can be shifted to the foreign producer. But these conditions are rarely present and unless they are present the import duty must be borne by the home consumer.

Export duty is similarly borne by the exporter. The price in the world markets is fixed so far as he is concerned. No individual exporter is in a position to influence the world price. But, here again, we can imagine a situation in which the exporter is in an exceptionally strong position so that the export duty can be shifted to the foreign purchaser. For example, we may have a monopoly of the supply of a commodity and the demand of the foreigners for our product may be inelastic, whereas so many other alternative markets may be open to us. In such circumstances, we can certainly make the foreigners pay the export duty by raising the price of the commodity by the full amount of the duty. But such conditions are very rare and, unless they are present, the export duty must be borne by the exporter.

Dalton lays down the rule in this connection thus: "Taxes on imports and exports may then be regarded as obstacle to exchange and, in accordance with the preceding theory, the direct money burden of any such obstacle is divided between the two parties of the exchange in inverse proportion to the elasticities of their respective demand. In other words, it is divided in direct proportion to the urgencies of their respective needs which are satisfied by the exchange."

EFFECTS OF TAXATION ON PRODUCTION, CONSUMPTION AND DISTRIBUTION

In earlier chapter (61), we discussed the effects of public expenditure on production and distribution. Let us now study the effects of taxes on production and distribution.

Effect on Production

Production is affected by taxes in two ways: (a) by affecting ability to work, save and invest and (b) by affecting the desire to work, save and invest.

Effect on the Ability to Work, Save and Invest. This effect will depend on so many factors including the nature of the tax and the reaction of the tax payers to the tax. We can take a few instances: A tax on the necessaries of life, will obviously affect the worker's productive efficiency and hence reduce production. This adverse effect on production can be avoided by exempting the goods of mass consumption or tax them at very low rates. A heavy tax on income tends to reduce the ability to save and invest on the part of individuals. A tax on the net profits of business firms will reduce their ability to save and invest. A decrease in investment is bound to affect adversely the level of output in the country. But increase in government expenditure may offset the decrease in investment in the private sector.

In an inflationary situation, taxes will tend to contain inflationary pressures and in a normal situation, high taxation will result in the fall of the price level and decline in output.

Effect on the Desire to Work, Save and Invest. Normally, taxation induces the people to work harder, earn more, save more and invest more to increase their income or enjoy the same income after tax. Some taxes have no adverse effect, *e.g.*, a tax on windfalls, inherited wealth, tax on monopolies irrespective of the output. Import duties too increase the domestic producers' desire to work save and invest. Low export duty may also encourage production. Excise duties or sales tax may not affect the people's desire to work, save and invest if they are spending only a small portion of their income on the taxed commodities. But if they are spending a large proportion of their income on such commodities, savings will fall and a fall in demand may also reduce output.

High marginal rates of income tax are likely to affect adversely the tax payers' desire to work, save and invest. The government usually allows developmental rebates, tax holidays, higher depreciation allowances to minimise the adverse effects. Expenditure tax tends to generate deflationary tendencies and by reducing profit it adversely affects the desire to save and invest.

As compared with income tax, the death duties do not adversely affect the desire to work, save and invest. But if it is intended to leave a certain size of property to the heirs, the desire to work and save will be adversely affected.

The effect on the desire to work, save and invest will largely depend on the reaction of the tax payers.

This reaction varies from individual to individual. It depends on the individual's elasticity of demand for income, *i.e.*, individual's keenness to earn an income. When an individual's demand for income is relatively elastic, the tax will lessen his desire to work and save. The effect will be the opposite if this demand is relatively inelastic. This is actually the case in the real world. Hence, a tax will induce the tax-payers to work more, save more and invest more, especially those who want to maintain a certain standard of living or earn certain amount on their savings, or who want to improve their social status or acquire power or those who wish to provide comfort and security in old age, and so on.

Production Pattern. Taxes may modify the pattern of production. Entrepreneurs may avoid the production of goods which are taxed. There is likely to be a diversion of resources from some sectors of the economy to others. For instance, if luxuries are heavily taxed production of necessaries may be stimulated. There will be diversion from the present to the future if consumption is taxed and savings are encouraged.

Effect on Income Distribution

Modern governments levy taxes not merely to raise revenue but also to levy such taxes as would reduce economic inequalities. It is recognised that if economic welfare of the masses is to be promoted, incomes and wealth in the country must be more evenly distributed.

The effect of taxes on income distribution depends on the type of taxes and the rates of taxes. Taxation of goods of mass consumption are regressive and redistribute incomes in favour of the rich. But if such commodities are exempted and luxuries are taxed, and taxation is made progressive, then incomes will be redistributed in favour of the poor.

The direct taxes like income tax, wealth tax, death duties and property tax levied at progressive rates tend to reduce inequalities of income and wealth.

It may, however, be emphasised that taxation alone cannot reduce economic inequalities. But levy of progressive direct taxes combined with public expenditure, mainly for the benefit of the poor, may go a long way in lessening economic inequalities. However, extremely high progressive rates may adversely affect production.

Effect on Consumption

Taxes can affect consumption in a number of ways. By imposing a heavy tax on a consumable good which is injurious to health, its consumption can be checked. It raises its price and reduces the demand for it. Similarly, by taxing luxuries, their consumption can be decreased and resources diverted to the production of goods of mass consumption. Taxes on necessaries are not considered desirable since their prices for the poor people will rise and their standard of living will fall.

Conclusion

Thus, taxation plays a regulatory role. It regulates consumption, production and income distribution. Taxation alone, however, may not be able completely to regulate them. It may have to be supplemented by other measures of control to make its regulatry role effective.

MODERN THEORY OF SHIFTING AND INCIDENCE

Various theories have been put forward to explain the shifting and incidence of taxation.

Earlier Theories. The earlier theories may be classified into (a) Concentration Theory or Surplus Theory and (b) Diversion or Diffusion Theory. According to the concentration theory or the surplus theory, each tax tends to concentrate on a particular class of people who happen to enjoy surplus from their products. The diffusion theory held on the other hand, that the tax eventually got diffused in the entire society. That is, the final resting place of the tax is not one but multiple. The process of diffusion took place through shifting or through the process of exchange.

Modern Theory. The concentration theory and the diffusion theory are only partially true. Actually, there is both concentration and diffusion of taxes according to the conditions present. The modern theory seeks to analyse the conditions which bring about concentration or diffusion.

Take a tax an a commodity payable by a producer. A producer has a dual price-relationship. He has price-relationship with he customers through selling price as well as with the suppliers of factors of production through purchase price. The producer will try to shift the tax to the customers by raising the price or to the factors by reducing the price he has to pay. The former is called forward shifting and the latter backward shifting. It is possible that the producer is able to shift it partly to the customers and partly to the factors of production and in this way shake off the entire tax burden.

Backward shifting is by and large, difficult because factor remuneration is determined by market forces of demand and supply. As regards forward shifting, we notice that the producer enjoys surplus in the form of profits and the consumers enjoy consumer's surplus. The producer wants to retain his entire surplus, whereas the consumer resists a reduction in his surplus. The producer will threaten to cut production and the consumer to cut consumption. In this way, the shifting will depend on the conditions of demand and supply.

65 PUBLIC DEBT

Public debt refers to borrowing by a government from within the country or from abroad, from private individuals or association of individuals or from banking and non-banking financial institutions.

CLASSIFICATION OF PUBLIC DEBT

Public debt may be classified as under:—

1. **Internal and External.** Internal debt is raised from within the country and external debt is owed to foreigners or foreign governments or institutions.

2. **Productive and Unproductive.** The productive debt is expected to create assets which will yield income sufficient to pay the principal and interest on the loan. In other words, they are expected to pay their way; they are self-liquidating. On the other hand, loans raised for war do not create any asset; they are a dead weight and are regarded as unproductive.

3. **Short-term and Long-term.** Short-term loans are repayable after short interval of time, *e.g.*, Treasury Bills payable after three months, ways and means advances from the Central bank. They are intended to bridge the gap temporarily between current revenue and current expenditure. It is called floating debt

Long-term loans are payable after a long time covering several years. They are also called funded debt.

GROWTH OF PUBLIC DEBT

Borrowing by public authority is a modern practice. In the past, whenever there was an emergency, usually a war, the monarch relied on the hoarded wealth or borrowed on his own personal credit. Books on history abound in instances of fabulous hoards and accounts of loots and sacks of hoarded wealth either from king's treasuries or from temples and churches. But this method of finance is not suited to modern conditions. It will be inadequate and uneconomical.

The system of public credit, making it easy for the States to borrow, has led to tremendous increase in the indebtedness of modern States. The public debt of 27 countries in 1900 was £6,079,000,000, in 1913 it increased to £8,566,000,000; and in 1933 to £22,000,000,000. Almost the sole responsibility for this phenomenal increase lies on war. The net cost of the war of 1914-18 was estimated at £42,000,000,000. The war of 1939-45 was infinitely more costly.

Causes of Increase in Public Debt

Besides war, there are several other causes which have brought about great increase in the size of public debt:

(i) The most important cause of increase in public debt is war or war-preparedness. Nations attach a great importance to their territorial integrity and they consider no sacrifice too much to defend their country. Every war, therefore, leaves the country under greater debt.

(ii) The increase is also due to fairly frequent budget deficits on current account. The deficits arise from the necessity of maintaining full economic activity in the economies which may have ceased to expand.

(iii) Increase in public debt is also due to the undertaking of welfare schemes by governments in modern times.

(iv) In public utilities, where there is no convenient profit check, no tight control over costs can be maintained and there are more losses than gains. They also add to the weight of public debt.

(v) In recent years, urge for economic growth has induced the under-developed countries to contract debts both internally and externally. The volume of public debt has consequently swollen.

Purposes of Public Debt

The following are the principal purposes for raising public loans:—

(i) **Bridging Gap Between Revenues and Expenditure.** It often happens that towards the end of the financial year, government experiences shortage of funds. To cover this gap between revenue and expenditure, the government raises temporary loans or gets 'ways and means' advance from the Central Bank. In India, the government issues what are called 'Treasury Bills' which are repayable after three months.

(ii) **Financing Public Works Programme.** During depression, the government has to launch public works programme to provide employment. In this way, money is injected into the economy to lift the depression. For this purpose, it becomes necessary to raise public loans to ensure economic stability.

(iii) **Curbing Inflation.** When inflation is rampant and it is desired to bring down the prices, the government issues public loans. In this way, money or purchasing power is drawn from the public. Reduction in money supply will bring down prices.

(iv) **Financing Economic Development.** The underdeveloped countries are now very keen on speedy economic development, which involves huge investment. They are unable to raise adequate finances through taxation. Hence resort to public borrowing becomes necessary.

(v) **Financing the Public Sector.** An economic system, which is becoming increasingly popular, is that of mixed economy. For several reasons, economic, political and social, there has to be a rapidly expanding public sector. The financing of this sector is not possible without resort to public borrowing.

(vi) **War Finance.** A modern war is a very costly affair. To prosecute a modern war by taxation is simply out of the question. Public borrowing becomes essential.

Thus, public borrowing is necessitated by the requirements of filling the gap between revenue and expenditure, public programme, economic development and war finance.

METHODS OF DEBT REDEMPTION

Modern governments make it a point of honour to repay their debts. Debt repayment maintains and strengthens the national credit. If a national emergency arises later, it will be easy to raise funds. Repayment of loans also releases funds for trade and industry.

The following are some of the methods adopted:—

(i) **Utilization of Surplus Revenue.** This is an old method and badly out of tune with the modern conditions. Budget surplus is not a common phenomenon. Even when there is a surplus, it is insignificant that it cannot be used for making any substantial reduction in the public debt.

(ii) **Purchase of Government Bonds.** The government may buy its own stock in the market, thus wiping off its obligation to that extent. This may be done by the application of surplus revenues or by borrowing at low rates, if the conditions are favourable.

(iii) **Terminable Annuities.** When it is intended completely to wipe off a permanent debt, it may be arranged to pay the creditors a certain fixed amount for a number of years. These annual payments are called annuities. It will appear that, during the time these annuities are being paid, there will be much greater strain on the government finances than when only interest has to be paid.

(iv) **Conversion.** This is a method for reducing the burden of the debt. A government may have borrowed when the rate of interest was high. Now, if the rate of interest falls, it can convert a high-rated loan into a low-rated one. The government gives notice to the creditors that they should either agree to reduce the interest rate for future payments or it will exercise the option of repaying the loan. In case the bond-holders do not accept the lower rate, then the government will raise a new loan at lower rate of interest and, with the proceeds, pay off the old debt. The effect is to convert a high-rated loan into a low-rated one. The financial burden is consequently reduced.

(v) **Sinking Fund.** This is the most important method. A fund is created for the repayment of every loan by setting aside a certain amount every year out of the current revenue. The sum to be set aside is so calculated that over a certain period, the total sum accumulated, together with the interest thereon, is enough to pay off the loan.

Some Revolutionary Proposals

Apart from the above methods of repayment of debts normally adopted by modern governments, sometimes unorthodox and revolutionary proposals are also made from time to time for wiping off or reducing public debt, *e.g.*, Debt repudiation, compulsory scaling down of capital and/or interest and capital levy.

These methods are not considered honourable and no responsible government entertains such proposals. Hence, they need not detain us.

BURDEN OF PUBLIC DEBT

In order to assess the burden of public debt, we shall have to consider the nature and the purpose of the public debt. If the debt is taken for productive purposes, *e.g.*, for irrigation and railways, it will not mean any burden. On the other hand, it will confer a benefit, provided the scheme has been successfully

executed. But if the debt is unproductive, it will impose both money burden and real burden on the community. The measure of the burden will depend on whether the debt is internal or external.

Burden of Internal Debt

Internal debt involves a series of transfers of wealth within the community. For example, when the loan is raised, money is transferred from the lenders to the government. The government then makes payments to contractors, government servants or to those people from whom it buys goods and services. Money is, thus, transferred from some sections of the community to the other sections. In this case, there is obviously no direct **money burden** of the debt on the community as a whole.

But there will be a direct **real burden** (*i.e.*, sacrifice, hardship or loss of economic welfare) on the community depending on the nature of these transfers of wealth. If by these transfers, wealth comes to be more evenly distributed, *i.e.*, wealth is transferred from the rich to the poor, then public debt will be considered beneficial instead of being burdensome. If, on the other hand, the public debt enriches the rich at the expense of the poor, it imposes a real burden.

Let us analyse carefully the nature of the transfer. In order to repay the interest and the principal of the debt, the Government must levy taxes. What the tax-payers pay, the bond-holders receive. The bond-holders are generally rich people. But the tax burden does not exclusively fall on the rich, unless it is very sharply progressive which is seldom the case. The tax burden falls on the rich and the poor both, and, in the case of indirect taxes, it may be more on the poor than on the rich. The net result may be that the wealth is transferred from the poor to the rich. This means a net loss of economic welfare.

This burden is accentuated by the fact that the transfer is from the young to the old (the bond-holders, the creditors of the government, are generally advanced in age) and from the active to the passive members of the community. "Here", says Dr. Dalton, "if nowhere else in the sphere of public finance, the voice of equity rings loud and clear. There is also a general presumption, on grounds of production (besides those on grounds of distribution) against the enrichment of the passive at the expense of the active, whereby work and productive risk-taking are penalised for the benefit of accumulated wealth."

Thus, internal debt has adverse repercussions both on production and distribution of wealth. This is its direct real burden.

Its **indirect real burden** will lie in the **check it imposes** on production. The production is likely to be checked, if the desire and ability to work and save are reduced. If the repayment of debt involves very heavy taxation, it is likely to reduce the ability and the willingness to work and save.

Burden of External Debt

The external debt also involves a series of transfers of wealth but not within the same country like the internal debt. This makes all the difference. When the loan is raised, wealth is transferred from the lending to the borrowing country, and when it is repaid the transfer is in the opposite direction. The account of money paid by the debtor-country towards interest and the principal is the measure of the **direct money burden** on the community.

But if we want to know the direct real burden (*i.e.*, loss of economic welfare), we shall have to consider the proportions in which the rich and the poor contribute to these payments. The government will raise the required money by taxes. If the taxes fall largely on the rich, the direct real burden will be less than it would be if the incidence is largely on the poor. The payment that we make to the foreign creditor gives him a control over our goods and services. He does not take away our money; it is of no use to him. He buys with that money goods in our country. An external loan thus sets up a drain of goods from our country. In the absence of debt payments, these goods would have been enjoyed by ourselves. This means a diminution of economic welfare; hence a **direct real burden.**

The indirect burden of the foreign debt lies in the check to production of wealth in the economy. Taxes imposed, in order to raise funds for debt payment, may reduce willingness and ability to work and to save. The debt payment made by the government may reduce public expenditure in the directions which would have stimulated production. Hence, production may be checked.

International payments can be made only by exporting goods. For this purpose, a country must produce more. Hence, it is said that production is stimulated. But production is stimulated only in certain directions. There is no general increase in production and employment. Factors of production are limited. If they are needed in the export industries, they will have to be drawn from the other industries which must consequently shrink. Thus, there is only a diversion of resources and no net increase in production and employment.

ROLE OF PUBLIC BORROWING IN A DEVELOPING ECONOMY

A developing economy has to tap all possible sources to mobilise sufficient financial resources for the implementation of its economic development plans. It has to utilise revenue surplus for the purpose, seek external aid, pitch up its level of taxation and resort to public borrowing in addition. But taxation and public borrowing are the two major instruments of resource mobilisation.

Public borrowing has one advantage over taxation. Taxation, beyond a certain limit, tends to affect economic activity adversely owing to its disincentive effect. There is no such danger in public borrowing. It does not have any unfavourable repercussions on economic activity by being disincentive, partly because of its voluntary nature and partly because of expectation of return and repayment.

According to expert opinion, taxation should cover at least current expenditure on normal government services, and borrowing should be resorted to to finance government expenditure which results in creation of capital assets. In that case, growing public debt will not be a burden on the economy, because such a debt is self-liquidating. But there is a limit to public borrowing, which is considered safe. Additional taxation is also necessary to implement the development plans.

The classical theory frowned upon public borrowing. It was thought that the use of resources by the government was less productive than their use in private hands. But the classical reasoning was based on the assumptions of full employment, inelasticity of money supplies and unproductiveness of public expenditure. These assumptions, we know, are not valid today. Public borrowing for financing productive investment generates additional productive capacity in the economy, which otherwise would not have been possible. It is used as an instrument to mobilise resources which, in an under-developed economy, would otherwise have gone into hoards or invested in real estate or jewellery. Public debt would thus divert the flow of resources into the right channels.

Thus, in an under-developed economy, public borrowing, if prudently managed and skilfully operated, can become a powerful instrument of economic development.

Besides, growing public debt provides the people opportunities to hold their wealth in the form of safe and stable income-yielding assets, *i.e.*, government bonds.

Growth and composition of public debt provides the monetary authorities with assets which they can manipulate to give effect to a monetary policy considered desirable in the context of economic development. Thus, monetary policy, which is considered essential for achieving the objectives of economic policy, becomes vitally related to public debt management. The management of public debt is used as a method to influence the structure of interest rates.

Thus, a growing public debt, in an under-developed economy, has become a powerful tool of developmental monetary policy.

There are two important ways in which the governments of under-developed economies raise resources through public loans: (a) **market borowing**, *i.e.*, sales to the public of government bonds (long-term loans) and treasury bills (**short-term** loans) in the capital market, (b) **non-market borrowing**, *i.e.*, issue to the public of debt which is not negotiable and is not bought and sold in the capital market, *e.g.*, issue of national savings certificates and national plan bonds and accepting deposits in the government post offices.

Voluntary or Forced Loans

Most of the types of public loans are voluntary. But, if the voluntary loans do not prove sufficient for the purpose, forced loans become necessary and are resorted to. An important example of forced loans familiar in India is that of Compulsory Deposit Scheme. Compulsory borrowing is a compromise between taxation and borrowing. Like a tax it is a compulsory contribution to the government but like a loan, it is to be repaid with interest.

Compulsory loans have a special advantage in the context of an inflationary situation and are superior to voluntary public borrowing. They sterilise funds, whereas voluntary public loans result in the creation of readily cashable bonds. They are monetised to increase liquid assets in the community which produce an inflationary effect. Also, lower rate of interest can be paid on compulsory loans thus reducing the most of public debt. But a continuous policy of compulsory borrowing may arouse public resentment. Normally, it is the voluntary public borrowing programmes which should be chiefly relied upon.

Difficulties of Public Borrowing in Under-developed Countries

Public borrowing, however, has to face special difficulties in under-developed economies: (i) There are no organised capital and money markets and, where they exist, they constitute a very small portion of the total capital and money markets in the country. Also, there may be no organic relationship between the organised and unorganised markets. Besides, the resources of the organised capital market are too inadequate to fulfil the capital needs of the economy.

(ii) Special difficulties of public borrowing in the under-developed countries arise from the fact that the people have a predilection in favour of investment in real estate, that gives them social prestige and for jewellery because it can be easily concealed and can be easily converted into cash in case of need.

(iii) A substantial volume of savings in these countries originates in the rural sector but these people have no tradition of investment in trade and industry. The rural saving cannot be mobilised effectively because rural incomes do not move through monetary channels. That is why most of the financial institutions are concentrated in the urban areas. Also, agricultural interests are entrenched

strongly, politically and resist all proposals to tax them.

(iv) The prevalence of very high rates of interest militates against the flow of funds towards agricultural improvements, savings accounts, government bonds, small-scale industry or other channels of investment where the yield cannot be so high.

(v) The response to government securities is also poor because of rising prices which reduce the value of the yield from government securities.

Conclusion. But in spite of these difficulties and limitations, public borrowing remains a powerful instrument of resource mobilisation. It is not only a necessary supplement to taxation but also very desirable form of capital mobilisation.

Suggestions for the Success of Public Borrowing

(i) In order to mobilise financial resources through public borrowing, the denomination of the loans, rates of interest and the periods of maturities should be adjusted to suit the preferences of different kinds of investors.

(ii) Also, it is necessary to stabilise the prices of government bonds so that public confidence in the government bonds is retained and response to future issues is encouraging.

(iii) Financial institutions should be set up to attract voluntary savings.

(iv) The facilities for deposit of savings should be varied and widespread and easily accessible.

(v) A reasonable stability in the value of money (*i.e.*, price level) must be assured, otherwise confidence of the savers will be shaken and saving will be discouraged.

(vi) Some under-developed countries have found the lottery system very useful because, according to this system, savings are attracted at lower rates of interest. Thus, prize bonds have been issued to attract savings into the public sector.

(vii) A suitable monetary policy constitutes an important factor in the success of the borrowing programmes of governments in under-developed countries. The aim of the monetary policy is to maintain sufficient liquidity in the economy as a pre-requisite of the success of the borrowing programme. A growth-oriented monetary policy has to be both regulatory and developmental.

Effects of Public Debt on Production, Consumption, Distribution and Level of Income and Employment

In modern times, public borrowing is both extensive and intensive. Almost all countries resort to public borrowing and they get deeper and deeper into it. Financial operations, which public borrowing of modern dimensions involve, are bound to affect production, consumption, distribution and the level of income and employment in the country.

Effect on Production

Vast sums are raised through public loans by modern governments both in the domestic capital market and abroad. They are raised to finance productive enterprises of various kinds, *e.g.*, steel works, multipurpose projects, construction of ships, railway lines and national highways, heavy electrical and engineering works, and so on. Obviously, such enterprises build up the economy's production base and, in course of time, make an enormous increase in the country's output. Public borrowing transforms inactive bank balances of the people into active capital. Repayment of loans also transfers money from expenditure to savings. Thus public borrowing stimulates the process of capital formation which increases the productive capacity of the country.

Effect on Consumption

When people subscribe to government loans, they generally have to curtail consumption. In this way, the propensity to consume is curbed. Since investment of funds raised by borrowing raises the level of employment, and so increases people's incomes, their consumption is increased. Much, however, depends on the manner in which funds raised by public borrowing are spent by the government.

Effect on Distribution

Public loans transfer money from the rich to the government. But the fiscal operations in modern times are meant to benefit the poor primarily. Either the incomes of the poor increase directly through increased employment or it benefits them indirectly through the enlargement of social services. In this way, national wealth comes to be redistributed in favour of the poor. In India, the Prime Minister's 20-Point Programme is aimed at reducing poverty. To the extent it is financed by public borrowing, public loans will have been used to change the distribution of wealth in the country. The rich will become less rich and the poor less poor. In this way, the gulf between the rich and the poor will be narrowed.

Effect on the Level of Income and Employment

In modern times, public borrowing is resorted to in order to raise funds for financing agriculture, industry, extension of the means of transport and communications or for construction of major irrigation works. Sometimes local development projects are launched to increase employment opportunities in rural areas. In this way, not only are the economic activities in the country multiplied but the volume of employment is also increased and the level of incomes goes up.

66 DEFICIT FINANCING

In the face of a fall in private spending, the use of deficit financing to maintain total spending or effective demand in the economy at the level required to buy the full employment output at the current level of prices, was an important discovery of the Depression Economics of nineteen-thirties. To-day, it is a major instrument in the hands of governments in the advanced countries to ensure continued high levels of economic activity. Lately, the under-developed countries have increasingly realised its potentialities for adding to the resources available for development. India has made quite a liberal use of deficit financing to carry her economic development plans through.

Definition

It is not possible to give precise definition of deficit financing applicable to all countries at all times. The definition of deficit financing adopted by the Planning Commission in India is that it is equal to the net increase in the purchasing power of the economy arising out of the budgetary operation of the government. Deficit financing is said to have been practised whenever government expenditure exceeds the receipts from the public like taxes, fees and borrowings from the public. Such an excess of government expenditure can be financed either by drawing down the cash balances of the government (held in the Reserve Bank of India or in the State treasuries) or by borrowing from the Reserve Bank of India. Both these methods of financing the deficit would have the effect of expanding money supply held by the public.

"The term deficit financing is used to denote the direct addition to gross national expenditure through budget deficits whether the deficits are on revenue account or on capital account. The essence of such a policy, therefore, lies in government spending in excess of revenue it receives in the shape of taxes, earnings of State enterprises, loans from the public, deposits and funds and other miscellaneous sources. The government may cover the deficit either by running down its accumulated balances or by borrowing from the banking system mainly from the Central Bank of the country and thus creating money."

The pre-budget Economic Survey for 1974-75 defines deficit financing as "the net credit given to the government sector by the Reserve Bank."

Thus, deficit financing is that part of government expenditure which is met either by drawing down the cash balances of the government or by resorting to borrowing from the Reserve Bank of India. This definition of deficit financing, therefore, identifies it with that part of government expenditure the finance of which leads to a net increase in money supply with the public.

There is a difference in the method of deficit financing practised by the developed countries and the under-developed countries. In advanced countries, deficit financing takes place by the Government borrowing from the banking system when the Government sells government securities either to individual bank depositors or directly to the banks. In both cases additional credit is created by the banking system. In the case of under-developed countries, where the banking habit is not fully developed, deficit financing takes the form of the government borrowing from the central bank instead of the banking system in general. The central bank issues paper currency in lieu of the government securities deposited with it. Thus, deficit financing in the ultimate analysis means issuing of more notes.

Deficit Financing and Deficit Budgeting. Deficit financing may be distinguished from deficit budgeting. When current expenditure exceeds current revenue it is said to be deficit budgeting. In this case, no item on capital account is taken into consideration.

On the other hand, when we take into consideration not only current receipts but also receipts on capital account, *e.g.*, public borrowing, and we still find a gap between receipts and expenditure, the method of financing used to cover this gap is called deficit financing. In other words, in the case of deficit financing, the volume of deficit budgeting is measured in terms of the overall budget deficit, *i.e.*, the aggregate of the deficit on both the revenue and capital accounts.

Uses of Deficit Financing

There are three types of situations in which resort to deficit financing becomes necessary

(a) For prosecuting a war,
(b) for fighting depression, and
(c) for financing economic development. We shall leave out war and discuss the other two uses.

Deficit Financing during the Depression

We have discussed, in the chapter on Trade Cycle (Ch. 47), the causes of unemployment in advanced and developed countries. There we observed that a deficiency of effective demand is the major cause of cyclical unemployment. In a situation like this, the obvious remedy is to boost effective demand. The government can assist in this process in a number of ways. It can stimulate private consumption and investment. It can do so by lowering the tax rates while maintaining its own expenditure. In this case, since the government is spending more than it raises in taxes, it is practising deficit financing, the deficit being covered by borrowing.

If, however, this method of stimulating economic activity does not produce sufficiently effective results, the government can increase its own expenditure on public works programme. The government's tax revenue remains constant but its expenditure has gone up, the deficit once again being met by borrowing. In this case, as government investment rises, the level of national income and employment also increases by multiplier times the increase in primary government investment.

Thus, deficit financing can be used to create additional employment, when the economy is suffering from a deficiency of effective demand. It is an instrument of recovery after depression. It is used to mitigate the severity of cyclical fluctuations. In this context, it takes three forms, *viz.*, pump priming, cyclical deficit spending and secular deficit spending to fill the inflationary gap.

This line of approach was made fashionable by the late Lord Keynes. Before him, there was a great deal of prejudice against a government, practising deficit financing. The classical economists were against deficit financing, except for financing productive enterprises. This opposition to deficit financing, on their part, was based on the assumption that in a private enterprise economy the level of activity had the tendency to be always full—an assumption we discussed in an earlier chapter under Say's Law of Markets (Ch. 39). Obviously, if there is already full employment in the economy, government expenditure, financed by the created money, is bound to create inflationary rise in prices. This fear of inflation constantly haunted the classical economists, and this was their main argument against deficit financing.

Lord Keynes, however, established it conclusively that in a situation, where there was large-scale unemployment of labour and excess capacity in the stock of capital, the fear that deficit financing would create inflation was baseless. For, when more employment was created by deficit spending on the part of the government, there would simultaneously take place an increase in the supply of output. When there is depression, an increase in supply can be had without any rise in average and marginal costs of production, so that additional demand creates additional supply of output without any rise in prices.

Thus, during depression, deficit financing can be safely used to expand income, output and employment without any inflationary danger. Rather, in a depression it is better to finance government expenditure by deficit financing than by increasing the rates of taxation. The latter alternative will not stimulate economic activity as much as the former, for the raising of tax rates must produce some adverse effects on private consumption and investment, and, hence will reduce the private effective demand. Thus, the expansionary effect of government expenditure will be partly neutralised by the contractionist effect of higher taxation on private investment and consumption. This adverse effect on the private sector will not be there, if additional government expenditure is financed by 'created' money and, therefore, the expansionary effect of government expenditure will correspondingly be greater. Increased spending offsets the deficiency of effective demand and puts into motion the stagnant wheels of the productive machinery. In this way, deficit financing makes for economic stability.

ROLE OF DEFICIT FINANCING IN A DEVELOPING ECONOMY

What scope is there for deficit financing to be used as an instrument of economic development in the under-developed countries like India? In the chapter on 'Determination of National Income' (Ch. 40), we observed that the basic problem confronting these countries is that of a population growing much faster than the rate of capital formation. If these countries are to provide full employment to their labour force, they need huge amounts of capital. Unlike the advanced economies, the problem facing under-developed countries is not one of deficiency of effective demand but of deficiency of capital.

In the advanced capitalist countries, the task of

capital formation is in the hands of private entrepreneurs; but, in poor countries there is a dearth of people willing and able to undertake entrepreneurial functions. Hence, if these countries are to develop rapidly, the responsibility must rest with the government.

Economic growth can be accelerated only by increasing the rate of investment. This requires additional resources and, in the absence of sufficient foreign aid, they can come out only through increased domestic savings, these being channelised along productive lines. One way of increasing domestic savings is through additional voluntary effort on the part of the public through small savings schemes. These savings add to the resources available to the government.

But, in a country, where a majority of people are living at the subsistence level, the margin between income and consumption is very low so that voluntary savings, howsoever welcome, cannot by themselves provide sufficient resources for development. The government may also attempt to increase the volume of resources by additional taxes. Yet, because of extreme poverty of the great mass of the people, additional taxation beyond a point raises difficult problems, both economic as well as political.

"Due to the low levels of income and high propensity to consume, aggregate savings in the economy are low. Investment being inadequate as compared to national requirements, the level of production, incomes, savings and thus of investment again, cannot increase sufficiently. It is, therefore, necessary to break such a vicious circle of poverty in these economies."[1] Since investment expenditure required for speedy economic development is too large to be financed through normal sources of revenue, deficit financing becomes inevitable.

As pointed out already, deficit financing results in the creation of new money. The increase in the money supply tends to raise prices because the supply of goods cannot be increased in the short run in proportion to increase in the people's purchasing power. As a result of rise in prices, entrepreneurs' profits go up and there is an increase in the inducement to invest on their part. Thus, there is increase in investment in the private sector.

Investment increases in the public sector too. Deficit financing puts in the hands of the government huge amounts of money with which they launch public enterprises, carry out multipurpose projects and build up the essential infrastructure. All this accelerates economic development. Thus, deficit financing gives the government command over productive resources which are utilised more fully and more fruitfully.

1. Kulkarni, R.G.—*Deficit Financing and Economic Development*, 1966, p. 32.

In this way, deficit financing stimulates economic development both in the public and private sector. It also promotes economic development by reducing consumption through a price rise.

In short, deficit financing accelerates economic development,

(a) by building up social and economic overheads,

(b) by using unemployed or under-employed resources and surplus labour more fully,

(c) by helping to create additional productive capital, and

(d) by mobilising additional resources for development.

Precautions

There is inherent danger of inflation in deficit financing which must be guarded against to ensure economic growth with stability. To avoid this danger, it will be necessary to take the following precautions in the use of deficit financing:

(i) Deficit financing should be used in moderate doses only and for this purpose constant watch should be kept over the price index.

(ii) The prices of consumers' goods and of essential raw materials should be effectively controlled.

(iii) To ensure a corresponding increase in the availability of goods, it will be necessary to concentrate on the quick-yielding projects.

(iv) In order to keep down the prices of foodgrains, food imports should be arranged well in time and in adequate quantities.

(v) The rise in wages and salaries should be checked lest the country should be caught in a vicious circle.

(vi) To withdraw from the public excess purchasing power, the excess money supply should be mopped up through taxation and borrowing and through attractive small savings scheme.

(vii) Above all, it will be essential to provide clean and efficient administration to ensure whole-hearted co-operation from the people in tackling the difficult economic situation resulting from a liberal use of deficit financing.

DEFICIT FINANCING IN INDIA'S FIVE-YEAR PLANS

Deficit financing was given a very important place in India's five-year plans, rather too much reliance on it. The following table gives the amount of deficit financing in the five-year plans in India:

Owing to unduly big doses of deficit financing, the Indian economy was really in a bad shape with almost a stagnant growth rate and spiralling prices annual inflation-rate reaching 32 per cent in Sept. 1974. That is why deficit financing was significantly

Deficit Financing in India's Five-Year Plans

Plan of Year	*Deficit Financing (Rs. Crores)*
First Five-Year Plan (1951-56)	333
Second Five-Year Plan (1956-61)	948
Third Five-Year Plan	1,133
Three Annual Plans (1966-69)	1,006
Fourth Five-Year Plan (1969-74)	2,060
Fifth Five-Year Plan (1974-75—1977-78)	1,426
Sixth Plan (1980-85)	5,000

reduced in the Fifth Plan to Rs. 1426 crores for the entire period of the Plan. 1974-78 (since it was terminated a year earlier). In the Sixth Plan (1980-85) Rs. 5,000 crores have been provided.

CONSEQUENCES OF DEFICIT FINANCING

The possible effects of deficit financing are:

(a) Increase in money supply with the public;
(b) the rise in the level of incomes; and
(c) the rise in the general price level.

Whether deficit financing is utilised for war purposes or for bringing about recovery after depression or for initiating the process of economic growth, the direct and immediate result is to increase the volume of total money supply with the public. However, the actual expansion of currency will depend on the credit policy of the central bank and the commercial banks and the balance of payments position.

Deficit financing also results in the increase in the level of incomes. Increase in government expenditure facilitated by deficit financing adds to the incomes of the people in the form of wages, salaries, rent, interest payments, profits, *etc.* Large amount of public spending promotes business investment and hence increases national income.

But the most striking effect of deficit financing is on the price level. Since, as mentioned above, deficit financing results in the expansion of money supply with the public, it tends to be inflationary. We discuss this effect in the section below.

Deficit Financing and Inflation

Deficit financing practised during the depression in advanced countries does not generate inflationary pressures, because of the elastic nature of the supply curves of output. Additional government expenditure leads to an increase in effective demand, depending on the magnitude of the multiplier. Similarly, when supply of output can be increased easily to match additional demand, there need be no inflationary pressures. In advanced countries, during the depression, there is lot of excess capacity in the economic system, so that an increase in output presents no difficult problems.

The situation in under-developed countries, however, is different. Here, an increase in investment does create additional demand, but a corresponding increase in the supply of output cannot be taken for granted. Firstly, an under-developed country suffers from the dearth of capital, and there is no excess capacity to be utilised for creating additional supply of consumers' goods.

Besides, the basic wage-goods industry, *i.e.*, agriculture, suffers from an inelastic supply curve, in the short run. In a subsistence agriculture, when the demand for agricultural products goes up, the farmer often lacks the willingness as well as the ability to increase his output.

The farmer's demand for non-agricultural consumers' goods is limited so that when agricultural prices rise relatively to the prices of industrial products, the farmer can satisfy his needs with less effort than before, and his reaction may well be to work less in the next period. Moreover, even if he wants to increase his output, his ability to do so is very limited. His holding is a small one and often lies scattered all over the village. He lacks resources to buy more and better seeds and manures; irrigation facilities are also lacking so that even with the best of wills in the world, unaided by any outside agency, the farmer's efforts to increase his output may not bear fruit.

Thus, in the absence of an elastic supply of consumers' goods, a development plan carries with it a great inflationary bias.

In the earlier stages of development, the inflationary danger is very real indeed. This is because of the urgent need to invest large sums in the creation of an adequate system of transport and communications. Such investments generate demand like any other investment outlays, yet they do not directly add to the supply of consumption goods. For all these reasons, deficit financing in under-developed countries is full of inflationary potentialities and these have to be watched carefully so as to keep them under control.

Not Necessarily Inflationary

As already mentioned, deficit financing results in a net increase in the money supply with the public. Of course, there is no direct relation between an increase in money supply and the inflationary rise in prices. If, for example, the newly created money is merely hoarded or saved, no inflationary pressure is generated. But to the extent that new money is used to offer additional employment to the hitherto unemployed or the new recruits to the working force, a large part of it will be spent and hence add to the volume of effective demand.

Similarly, if sufficient additional supply of consumers' goods can be made available with the help of additional investment, once again there need be no inflationary pressures and supply and demand may be in equilibrium at a higher level.

The inflationary impact of deficit financing also depends on the extent of monetisation of an economy. In case of a 100 per cent monetisation, the impact of a given amount of deficit financing will be less inflationary than when it is only partly monetised. In the case of non-monetised sector, the increase in money supply is to be viewed against that output which enters into monetary transactions.

The propensity to consume also affects the inflationary impact of deficit financing. In case propensity to consume is low, the inflationary impact is reduced, whereas a high propensity to consume intensifies the inflationary pressure. Since propensity to consume is constant in the short run, the inflationary impact cannot be managed through the marginal propensity to consume. Conversely, the inflationary impact of deficit financing will be less when the marginal propensity to save is high, and **vice versa.**

Also, the inflationary pressure generated by deficit financing depends upon the proportion which the amount of deficit financing bears to the total national income. The lower this proportion, irrespective of the amount, the lower will be inflationary impact. In other words, when the amount of national output rises proportionately to deficit financing, the prices too will behave proportionally and the inflationary impact will be lower. If deficit financing leads to utilisation of unused resources of the economy and results in increase in output, it will neutralise the inflationary impact.

The inflationary impact of deficit financing also depends upon the nature of public expenditure. If public expenditure only adds to money incomes without an increase in output, the inflationary impact will be higher. It will be lower if public expenditure goes into production of goods and services. On the whole, deficit financing generates inflationary pressures unless supply of goods is increased rapidly and sufficiently.

The management of inflation depends on the effectiveness of government controls, public cooperation and future outlook.

Minimising Inflationary Potential of Deficit Financing

The following measures will minimise the inflationary potential of deficit financing:

(i) **Fiscal Policy.** Through a proper disinflationary fiscal policy, the inflationary pressures generated by deficit financing can be controlled to some extent. This involves raising taxes on income and consumption and reduction of non-essential government expenditure. Through various tax measures, the government can mop up a part of the increase in incomes generated by the development expenditure. All these measures will reduce the pressure of demand on the available goods and services.

(ii) **Monetary Policy.** By adopting a restrictive monetary policy, non-essential private investment can be kept under control, thereby releasing resources for the expansion of essential investment.

(iii) **Economic Controls.** Through selective credit controls, physical and fiscal controls, the government can influence the behaviour of private investment and channelise it into desirable lines. For example, scarce materials can be rationed, building activity can be controlled and controls imposed on new capital issues by the companies.

(iv) **Proper Allocation of Resources.** All the above measures have for their aim the reduction of pressure of demand. But attempts should be simultaneously made to increase the supply of output of consumption goods. In this connection, a proper balance must be kept between agriculture and industry and heavy and light industries. Agriculture is the supplier of basic wage-good, *i.e.*, food. Therefore, a programme of economic development which fails to lay proper emphasis on the increase in agricultural production must run into inflationary difficulties. Similarly, industries requiring small investment and maturing quickly should also receive due emphasis.

(v) **Developing Import Surplus.** The supply of goods can also be increased by having an import surplus. In the Indian First Five-Year Plan, for instance, there was a provision for drawing down our sterling balances by Rs. 290 crores to finance imports in order to dampen the inflationary effects of deficit financing. (Actually, however, deficit financing was much higher than anticipated and withdrawal of sterling balances was smaller than expected). However, there is a limit to which a country can have an import surplus. This is limited by the availability of resources of foreign exchange previously accumulated or by receiving fresh foreign loans.

Thus, suitable fiscal and monetary policy can go a long way in counter-acting the inflationary effect of deficit financing. But beyond a limit, it is bound to prove inflationary.

Conclusion

The above discussion indicates alike the scope and limitations of deficit financing. Deficit financing has a definite place in development finance but it is desirable to keep it within "safe limits". The extent of deficit financing depends on our ability to control inflationary pressures by keeping demand in check as well as by simultaneous increase in production. It is indeed gratifying that through discipline and

hard work and realising the dangers of inflation, our country has a unique distinction of having successfully controlled inflation and actually achieving a negative rate of inflation. This has paved the way for economic growth with stability.

Concept and Principles of Federal Finance

Federal Finance seeks to maximise total welfare. The economic welfare of an under-developed region in a federation can be increased by the diversion of resources from the developed regions.

The general principle to maximise economic welfare is that each regional or State government should try to equate marginal social benefit (MSB) with marginal social cost (MSC). The federal government will try to do so for the whole country. Thus the principle of federal finance would be

$$MSBa = MSBb = MSBc \text{ and also}$$

$$MSCa = MSCb = MSCc$$

Here **a, b** and **c** are three regions or States.

Inter-Personal Equity: Equalising of marginal social benefits and marginal social cost in the union as well as the units would require a substantial inter-area transfer of resources in a federation for achieving what Prof. Buchanan calls **inter-personal equity.** Inter-personal equity means equal treatment to equals. Suppose the per capita in one federating unit is higher than in another. If the same amount of a tax is collected in both the federal units, (States) and the same amount of expenditure is incurred in both the states, the total tax collection and the total expenditure made in the rich state will be higher than in the poor state. The same amount of expenditure in both states would mean that a resident of the rich state will be subject to less tax than his equal income counter-part in the poor state. A transfer of resources will thus be necesary to achieve **horizontal equity.** Also, the total benefits derived by the individuals in the two units from public goods may not be equal, being more in the richer units than in the poor ones. This inequality too must be removed or minimised.

The two practical problems to be tackled in federal finance are (a) the allocation of resources between the different regional governments and (b) the balancing of resources with the needs of the regions. For the solution of these two problems, the following principles have been suggested. These may be called the principles of federal finance:

1. Uniformity. The principle of uniformity implies that there should be no discrimination in levying taxes between one unit and another. That is why, for instance, in India, income tax, central excise duties, etc. are levied by the Central government and sales tax, land revenue, etc. by the state governments.

2. Independence or Freedom. The federal constitution earmarks certain resources to the units in which they are free to levy taxes and also free to spend. There is no dependence on each other and the central government does not interfere. In this way, each unit will try to develop resources assigned to it.

3. Adequacy. It is also necessary that both the Central government and the federal units have at their disposal sufficient resources to carry on their normal functions, so that there is no dependence of one on the other.

4. Elasticity. The resources assigned both to the Centre and the states should be capable of expansion as the requirements increase. In India, this is made possible by the appointment of a Finance Commission every five years to recommend further devolution of resources.

5. Efficiency. Federal finance should also provide for efficiency or administrative economy. The taxes should be so levied and collected that there is minimum evasion and minimum cost of collection. Also, adverse effects on trade and industry should be minimised. To ensure the observance of this principle, taxes of inter-state importance are collected by the union government and taxes of state importance by the States.

6. Grants-In Aid to Deficit States. Since usually the State resources are compartively inelastic and inadequate to meet their requirements it is necessary that there should be a provision for grants-in-aid to meet these deficits. For instance, the Indian Seventh Finance Commission recommended a total transfer of Rs. 20,842 crores from the Centre to the states for the five-year period 1979-84.

Conclusion. The basic fiscal problems in a federation relate to allocation, distribution and stabilisation and it is the duty of federal finance to offer suitable solutions to these problems.

BOOK SIX:
ECONOMIC SYSTEMS

67 CAPITALISM

There is hardly any country today which can be called a pure free enterprise or capitalistic economy. Even the economies of the U.S.A. and the U.K., which are called capitalistic economies, are examples of mixed economies. But basically, they are still free market or capitalistic economies, because even now major role in their economies is played by private enterprise and capital.

Definition

Under capitalism, all farms, factories and other means of production are the property of private individuals and firms. They are free to use them with a view to making profit, or not to use them, if it so suits them. The desire for profit is the sole consideration with the property-owners in the use of their property. Besides free and unfettered use of their property, everybody is free to take up any line of production he likes and is free to enter into any contract with other fellow-citizens for his profit.

Although all modern States do impose certain restrictions on economic freedom in the interest of general welfare, yet even these restrictions leave much latitude to the propertied class to use their property in any manner they like, to start any business they think profitable to themselves, and to enter into contracts they think necessary in their own interest.

What to produce, how to produce and for whom to produce—all these central problems of economics are settled by the free working of the forces of demand and supply. The economic development of the U.S.A., the U.K. and the Western European countries took place under capitalism or under the system of free enterprise. In the words of Prof. Loucks, "capitalism is a system of economic organisation featured by the private ownership and the use for private profit of man-made and nature-made capital."[1]

The definition of capitalism, given by the Webbs, brings out the necessary implications of the system. They define it thus: "By the term 'capitalism' or the capitalistic system' or as we prefer the 'capitalist civilisation', we mean the particular stage in the development of industry and legal institutions in which the bulk of the workers find themselves divorced from the ownership of the instruments of production in such a way as to pass into the position of wage-earners whose subsistence, security and personal freedom seem dependent on the will of a relatively small proportion of the nation, namely, those who own and, through their legal ownership, control the organisation of the land, the machinery and the labour forces of the community and do so with the object of making for themselves individual and private gains".

Outstanding Features of Capitalism

A study of capitalism reveals several outstanding features of this system:

(i) **Right of Private Property.** The most important feature of capitalism is the existence of private property and the system of inheritance. Everybody has a right to acquire private property, to keep it, and, after his death, to pass it on to his heirs. The result of this system is that inequalities of wealth distribution are perpetuated. The rich people become richer and the poor become poorer.

Allied with this feature is another, *viz.*, that instruments for production are owned by private individuals and they are managed by the owners of farms and factories. They carry on the business of agriculture, trade and industry for their own personal profit and not for the benefit of the society. The result is that the lion's share of the national dividend goes to the powerful capitalist and the rich landlord. The masses are exploited and do not get a fair return on their labour.

(ii) **Freedom of Enterprise.** A very outstanding

1. Loucks—*Comparative Economic Systems.*

feature of the capitalistic order of the society is economic freedom. This freedom implies three things: (a) freedom of enterprise, (b) freedom of contract, and (c) freedom to use one's property. Everybody is free to take up any occupation that he likes or start any business he likes and to enter into contracts or agreements with his fellow-citizens in a manner most profitable to him. Every citizen has the freedom to form any firm or company and set up a factory anywhere he likes provided he has the requisite capital and ability.

Actually, however, there is no absolute freedom in these respects: In the interest of general welfare, certain restrictions are imposed by all States on individual rights. Freedom to choose one's occupation is only in name. Family influence, the resources of an individual, prejudices, and other social restrictions stand in the way of a person choosing the occupation that he likes. The result is that only poorly-paid occupations are open to the poor.

(iii) **Freedom of Choice by the Consumers.** Another important feature of capitalism is that every consumer enjoys a freedom of choice of the commodities and services that he wishes to consume. He cannot be forced to consume any particular commodity or service nor can he be forced to give up the use of any commodity or service. Under capitalism the consumer is sovereign. Of course, the consumer's sovereignty is limited by the consumer's income and the availability of goods. It is the consumer's likes and dislikes which determine the magnitude and pattern of production. (We discuss it more fully below).

(iv) **Profit Motive.** Still another characteristic of capitalism is that the profit motive of individuals governs business enterprise. It is the profit motive which induces people to undertake any productive activity. To make profit is the primary motive of entrepreneurial activity and not love of society or social service. Those commodities and services are produced under capitalism which are expected to yield maximum profit. Hence, what to produce and how much to produce is determined by individual profit rather than by social benefit. It is the profit motive which induces businessmen to make the optimum use of the factors of production. Thus, profit motive is the mainspring of all economic activity under capitalism.

(v) **Class-Conflict.** From this arises another feature of this economic order, *viz.*, that there is class-conflict. The society has been divided into two classes, the "haves" and the "have-nots" which are constantly at war with each other. Conflict between labour and capital is going on in all capitalistic countries, and there seems to be no near solution of this problem. One regards the other as its natural enemy. It seems that this class conflict is inherent in capitalism.

(vi) **Un-co-ordinated Nature.** A very remarkable feature of this economic order is its unco-ordinated nature. There is no conscious regulation or central direction of economic activity. Everything seems to go on automatically. Production is conducted as a result of the decisions of numerous isolated entrepreneurs. It is also at the same time influenced by the vast army of individual consumers who make their decisions without consulting one another. The consumer is the king. It is consumers' preferences (or aversions) which finally decide what should be produced and what should not be produced. They furnish the demand side and the unco-ordinated activities of the producers the supply side. Somehow the demand and supply adjust themselves to each other. Price serves as the sign-post or the signal. Price influences the consumers as well as the producers. That is why the present system has been described as a "government by price."

(vii) **Entrepreneur's Role.** A prominent feature of this economic order is the vital role which the entrepreneur plays under this system. The entire productive machinery of the country is under his direction. It is he who hires the other factors of production and undertakes to pay them. He is the sole agent of the community in the matter of production. It is difficult to see how the present system can work at all in the absence of the entrepreneur. Everything hinges on him.

(viii) **Control with Risks.** We also notice another feature of the present economic system, *viz.*, the control of business goes with risk. This has been called the Golden Rule of Capitalism. He who risks his money must also control the business. He who pays the piper must call the tune. If capital belongs to some other people and the control is vested in the hands of those who have no stake in business, we can imagine that the decisions will be made in a very irresponsible manner.

(ix) **Competition.** This is another characteristic of capitalism. The producers compete with one another to get the consumer's choice or in selling the commodity as much as they can through advertisement. They may cut the price or improve the quality of the product or offer other concessions to the purchasers. On the other hand, there is also competition among the buyers to obtain the commodity who bid against one another and offer higher prices for the purpose. Similarly, there is competition among workers for jobs.

It may also be pointed out that pure or perfect competition is rare in capitalism. In the real world, there is imperfect or monopolistic competition. Pure competition is only an exception. Also, the producers generally combine to form monopolies or oligopolies to maximise their profits by charging the maximum prices they can.

We may also notice that this economic order is not only based on competition, but also on combin-

ation or co-operation among the various interests. The buyers compete with buyers and the sellers with sellers; the labourers compete with one another in order to get jobs but they also combine in trade unions to fight the capitalists. Similarly, the employers not only compete among themselves but they also combine to form associations to safeguard their interests. Thus, under capitalism, combination and competition go side by side.

(x) **Importance of Price System.** Capitalism is said to be governed by price. It is the price-mechanism which facilitates the functioning of capitalism. It is the price which equates the demand and supply of commodities and factors of production For instance, if supply is short, price rises and demand is cut to the size of supply. If supply is large, the price comes down so that the extra supply is taken off the market. Price is a signal which guides the producers as to what to produce and what not to produce. A higher price is also a warning to the consumers to cut down their consumption.

(xi) **Economic Inequalities.** A feature of capitalistic countries is the glaring inequalities of wealth and income. A few are very rich indulging in all sorts of conceivable luxuries, whereas the masses are not able to get even two square meals a day. What is more painful is that the gulf between the rich and poor is ever widening. The inequalities arise from unearned incomes which are due to uneven distribution of wealth. Larger wealth yields higher income.

SOVEREIGNTY OF THE CONSUMER

Under capitalism or the system of free enterprise, the consumer has been compared to a king. The entire productive machinery is supposed to work under his sovereign sway. His whims, prejudices and desires seem to rule the world of production. The entrepreneurs of modern industry are his bond slaves and so many servants to carry out his commands. If the consumer is pleased, the entrepreneurs are happy and prosperous and if the consumer is dissatisfied, the entrepreneurs' fate is sealed. Thus, the consumer is said to be the monarch of all he surveys.

In the past, the consumer's rule was manifest. The consumer placed the order, say, for shoes, clothes, *etc.*, and the market simply carried out the order faithfully. The consumer got what he wanted. He was undoubtedly the sovereign.

But the modern producer does not work to order. He anticipates demand. It is the business of the entrepreneur to make a shrewd guess as to what would satisfy the consumer the most. Here again, the consumer's preferences exert their full weight. If the entrepreneur is not sufficiently intelligent to gauge rightly the requirements of the consumers, or if the prices fixed by him do not suit the pockets of the consumers, his goods will not sell.

In a capitalist economy, such ventures will succeed as satisfy the consumers the most. Universal consumption is something like universal suffrage; it is a democratic means of control. The only qualification required for consumption is the possession of income with which to acquire the desired goods. "In economic elections, a consumer casts as many votes as he has dollars to spend. If the economic electorate decides to spend its money for baubles instead of essentials, for shoddy goods instead of genuine articles, for things that are ugly instead of things that are beautiful, such things will be produced. Consumer's choice, whether it is wise or foolish, guides the operations of our industrial system. It is like closing an electric circuit and thereby turning on a current that sets the wheel of the productive mechanism into motion."[2]

Thus, the rationale of all economic activity is the satisfaction of the consumer's wants.

Limitations

But the consumer is not so despotic a monarch as he is supposed to be. At best his case may be one of constitutional or limited monarchy. A constitutional monarch reigns but does not rule. There are some serious limitations on the authority of our sovereign, the consumer:

The most important check on his authority arises from the **size of his income.** The things do not move according to his command unless he uses the money-whip. The consumer wants pure ghee but he has to be content with Dalda for lack of means to pay. Thus, the real wants of the consumers go unsatisfied under capitalism and only those wants can be satisfied which are expressed in money.

Further, the individual consumer does not count. It is only the combined demand which rules.

The satisfaction of the consumer depends on the **goods actually available** in the market. There are physical limitations too. Actual production depends upon technical knowledge at the moment, and the development of technique may lag behind consumer's desires. We want noiseless trains but we must wait till the technique develops. Consumer's preferences are generally ahead of what is available at the moment.

High pressure salesmanship and persistent advertisement modify the real desires of the consumers. The propaganda machinery is directed to mould and to control consumer's tastes. They are thus induced to buy something different from what they would have purchased otherwise. Our sovereign, the consumer, is impotent and helpless. That businessman succeeds who does not merely satisfy the felt

2. Kiekhofer, W.H., *Economic Principles, Problems and Policies*, 1936, p. 652.

wants of the consumers, but who is able to direct the consumers' tastes towards his particular brand. Huge amounts of money are being spent on advertisement in every country. At every strategic corner on the roadsides, on the railway platform, on the trunks of trees and telegraph poles, on the houses and buses and trams, a consumer is faced with attractive advertisements.

According to Ely, "Expenses in the United States for national advertising alone are estimated to average nearly 10 dollars for every man, woman and child. The cost of advertising in each issue of the *Saturday Evening Post* is nearly a million dollars."[3] Here is another estimate: "In the United States alone about half a million persons are normally employed in advertising and that nation's annual advertising bill runs from $1\frac{1}{2}$ to 2 billion dollars."[4]

These amounts are not being spent to please the consumer but to enrich the producer. Every rupee spent on advertisement and salesmanship is a nail in the coffin of the consumer's sovereignty. We do not agree with Benham when he says that a monarch may be advised and cajoled as to some of his activities even by his slaves, but he remains a monarch nonetheless. This is a case of nominal sovereignty, a very poor specimen of monarchy indeed.

Here is an evidence of the consumer's helplessness. "No doubt the public is spending a tremendous amount yearly—and it comes from those who can least afford it—for lamps that are both a fire and health hazard, for toasters that we dare not touch once they are heated up, for automatic irons that burn and destroy fine rayon goods when set for the lowest temperature, for curling irons, vibrators, massagers which are so poorly insulated that only a person totally ignorant to the potential shock of 110–120 volt supply would dare use such an appliance." This is true of most lines of production.

The monopolists too exercise control over the consumers. In modern times, there is a tendency towards combination or cartelisation, and a few firms or companies come to control the entire output. They can easily dictate their terms to the consumers, who have no say in the matter of price or the range of production.

Then, there is the **Government control** with which we have now become well acquainted. Even in normal times the government either prohibits or restricts the consumption of certain articles, *e.g.*, intoxicants. The Government can exert influence on the trends of production. Besides, the Government itself is the biggest consumer and is in a position to set the pace in the matter of price as well as the quality of goods produced.

Consumer's own habits bind him and he is reluctant to make any departure from his set scales of preferences. The freedom to choose, therefore, is not exercised.

Environments and **conventions of society** also exercise a restraining influence on the consumer's choice. Therefore, the unrestricted freedom of the consumer is a mere myth.

The **consumers are generally ignorant** and do not know what is best for them. Their blind choice does not always accord with their self-interest. Lack of knowledge, therefore, is another hindrance in the way of exercise of the consumer's sovereignty. If the consumer is a giant, he is surely a blind giant.

Production of standardised goods, irrespective of the individual tastes, is a conclusive proof that the modern economic system pays scant attention to the consumers' wishes. The consumers are bulked together and treated en masse, not like a king but a herd of sheep.

Conclusion

It is really very difficult to convince a poor villager or a factory hand that he is the sovereign of all he surveys and that factories are working, trains and ships are moving and the businessmen sitting at their shops or running to and fro in the market—are all trying to serve him and satisfy him rather than line their own purses.

The fact is that neither consumers nor producers alone are sovereign. Economic prosperity of a country lies in a proper balance between consumption and production. In the words of Ely, "Progress is dependent on alert and responsive consumers as well as on prudent and efficient producers. Sluggish consumers, sluggish producers."

MERITS OF CAPITALISM

That capitalism has survived for centuries and is still going strong shows that the system must have certain inherent merits. We may note below the main merits:

(i) **Automatic Working.** One merit of capitalism is that it does not require any central directing authority for its functioning. It functions automatically through the price-mechanism as we have explained above. If at any time, there is some disturbance in the economy, it is rectified through price change. On the contrary, socialism can function only through active state intervention. Thousands of people are employed in preparing a plan for working of the system and crores of rupees are spent in the formulation and implementation of the plan. But capitalism functions automatically through the price system without there being any need for

3. Ely, R.T.—*Outlines of Economics*, 1930, p. 145.
4. Kiekhofer, *op. cit.*, p. 154.
5. Moore and Others—*Modern Economics*.

incurring such expenditure simply to make the system work.

(ii) Higher Efficiency and Incentive to Hard Work. Another merit of capitalism is that under capitalism workers and entrepreneurs are encouraged to improve their efficiency and put in hard work. The entrepreneurs are induced to work hard and work more efficiently to earn higher profits. Since the more efficient and hard working labour can earn higher wages, they have the incentive to improve their efficiency. Hence, under capitalism, the entire manpower resources of the country (labour and entrepreneur) work the hardest and most efficiently. In this way, the national output increases and economic development is accelerated.

(iii) Higher Rate of Capital Formation. As we have already mentioned, people under capitalism have the right to hold property and pass it on in inheritance to their heirs and successors. Owing to this right, people save a part of their income so that it can be invested to earn more income and leave larger property for their heirs. The rate of capital formation increases when savings are invested. This accelerates economic growth.

(iv) Economic Development and Prosperity. The supporters of capitalism point to the rich variety and abundant supply of goods and services. The lure of profit compels the entrepreneurs to take risks, and to conquer new fields in production. Standard of living has risen all round, comforts of life have increased, and life has become richer and fuller. This is the service rendered by capitalism to society. As we have already said, capitalism offers great incentive for saving and large opportunities for investment. It encourages innovation and technological progress and the optimum use of resources. It is thus conducive to economic growth and prosperity.

(v) Optimum Utilisation of Resources. The limited resources of the community are put to the most economical uses with as little waste as possible. There is keen competition among producers and entrepreneurs to produce and sell goods. Every producer and entrepreneur tries to use the productive resources at his disposal in the most economical manner in order to make maximum profit. The person responsible for the waste receives prompt punishment for his miscalculation in the form of losses or bankruptcy. In this way, capitalism encourages the most efficient use of the resources of the country.

(vi) Just System. The richest reward under capitalism goes to the ablest, the most daring as well as the most prudent entrepreneur. A man who takes the initiative and shows extraordinary resourcefulness and pluck makes the highest profits. Nothing seems to be more just than that the rewards should be apportioned according to merit.

(vii) Democratic. The consumer's control gives the system a democratic tinge. Nobody likes that his consumption should be dictated by some superior authority. In the capitalist economy, an attempt is made to adjust production to the consumers' wishes. They consume what they like and not what is supplied to them. That is, the consumers control production. The consumers constitute the general public, Hence, the system is democratic.

(viii) Encouragement to Enterprise and Risk-taking. Another important merit of capitalism lies in this that it encourages the entrepreneurs to take risks and adopt bold policies, because in this way they can make higher profits. Higher the risk, greater is the profit. They also make innovations in order to cut their costs and maximise their profits. These innovations result in the improvement of production techniques and lowering of the costs of production. Hence, capitalism brings about a great technological progress in the country.

(ix) Adaptability. Finally, if the survival of the fittest is any criterion of the soundness of a system, capitalism is indeed sound and strong. So many crises have overtaken the system, but it somehow emerges, a bit crippled no doubt, but victorious. Its adaptability to the changing economic conditions is indeed surprising. What greater proof do we need of its toughness and resiliency than the wonderful manner in which it has stood the strain of costly wars?

DEMERITS OR CRITICISM OF CAPITALISM

But capitalism is now being assailed from all directions. The following are the main grounds on which it is attacked:

(i) Wasteful Competition. Competition, which is the cardinal feature of capitalist economy, is a sheer waste. Colossal expenditure is incurred on advertisement and salesmanship simply to defeat a rival. Resources employed by those who are defeated in the race, go to waste. Cut-throat competition does not confer any corresponding social benefit, though it may be advantageous to the firms concerned.

Competition results in the production of too many varieties. A reasonable variety is all right, because it offers alternatives to consumers. But too much variety is wasteful, because a small variety, but each large in quantity, can be more economically produced.

There is no doubt that the efficiency of th. capitalistic system depends on the existence of free competition and the mobility of the factors of production. But the existence of friction, legal, social and economic, hampers free competition with the result that the factors of production often lie idle.

(ii) Human Welfare Ignored. The supposed harmony between the interests of the consumers, *i.e.*, the society, and those of the producers, does not actually exist. Lack of free competition, deliberate

deceit practised by unscrupulous producers and the ignorance and the impotence of the individual consumer turn the consumer-king into an abject slave, a victim of exploitation. The economic decisions made by individual entrepreneurs and producers under capitalism are based on their self-interest and not from the point of view of good of the society. The producers produce those commodities and in such quantities that the difference between price and cost is the maximum so that their profit is maximised. However necessary and useful the commodity may be the producers will not produce it if price does not exceed the cost, because it is only the profit motive which drives them. Social welfare is ignored altogether.

(iii) **Economic Instability and Unemployment.** The recurrence of the trade cycles, due to over-competition and over-saving resulting in over-production, must be considered one of the bitterest fruits of capitalism. Production is unplanned and is being augmented by ever increasing accumulation of capital, while the bulk of the consumers are being impoverished more and more. In these circumstances, it will be a miracle if there is a proper balance between production and consumption. The result is economic instability. Booms are followed by slumps and when there is depression there is large-scale unemployment. The workers, who constitute the bulk of the nation, have to live under a perpetual dread of losing their job. They have no sense of security. There was mass unemployment during the Great Depression of 1929-34 and even political stability of certain States was threatened. When there is boom, there is the danger of inflation which also entails large-scale suffering especially of the poor and fixed incomists.

(iv) **Property Rights Take Precedence Over Human Rights.** Capitalism lays undue emphasis on property rights as against human rights. Man, the first of God's creation, is treated like an ordinary chattel. Money, not man, rules the world and debases humanity.

(v) **Class-Conflict.** Capitalism has sown the seeds of eternal social unrest by dividing the society into two hostile camps of capital and labour, the 'haves' and 'have-nots'. They look sullenly at each other, and are ever on the look out for an opportunity to fight. This is due to the fact that their interests continually clash. The labour wants higher wages and short working hours which is against the interests of capitalists. Strikes and lock-outs are inevitable.

(vi) **Social Injustice and Economic Inequity.** The extreme inequality of wealth distribution, which is being accentuated as time goes on, is the most galling outcome of capitalism. As G.D.H. Cole remarks, "There is a world of difference in terms of happiness between the high priest and the slaves in the temple of industry."[6] On the one hand, there are a few rich people and, on the other, the vast masses fabulously steeped in abject poverty. The former are enjoying a luxurious life even without working, whereas the latter cannot get two square meals a day even after putting in hard labour. They are clothed in rags and live in hovels and their children often die from lack of milk and medicine, whereas even the rich man's dogs are better fed. A system which results in such social injustice and economic inequalities deserves to be condemned.

Thus, capitalism is full of frustrating anomalies, the few indulging in all conceivable luxuries and the majority living under semi-starved conditions. The crops are rotting while human beings are starving, and machines are lying idle inside the factories, while unemployment is raging in all its fury outside.

(vii) **Misallocation of Resources.** Capitalism is also criticised on the ground of the misallocation of the productive resources of the country. Production under capitalism is not undertaken merely to satisfy the basic needs of the masses of people. The productive resources are utilised for the production of luxuries for the rich without producing sufficient quantity of goods for mass consumption. It is true that under capitalism production is carried on according to the wishes of the consumers. But since there are great inequalities in income and wealth, and demand depends on the purchasing power of the people, the rich people are able to exert greater pull in the product market.

The producers take decisions about production on the basis of market price, hence it is more profitable for them to produce luxuries because the rich people can buy them at higher prices. On the other hand, sufficient quantity of consumer goods cannot be produced for the poor because they cannot afford to pay sufficient prices for such goods. The aggregate satisfaction can be increased by using productive resources in the production of goods for the poor instead of for the rich. But this is not possible under capitalism where production is governed not by the wishes and needs of the poor but by market prices. The market prices are not a correct index of the wishes and needs of the general public, because the rich people are able to influence the market prices by their higher incomes.

(viii) **Emergence of Monopolies and Concentration of Economic Power.** It also happens under capitalism that perfect and free competition ceases to prevail and instead big combinations of powerful producers and monopolies emerge against whom it becomes difficult for an ordinary entrepreneur to compete. These big monopolies come to control the market on account of the huge resources that they command, and small producers are squeezed out.

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6. *Principles of Economic Planning*, 1935, p. 3.

Thus, under capitalism free enterprise is merely nominal; it is not free enterprise for all. Actually, only those entrepreneurs are able to undertake business who command large resources. The monopolists produce small quantity but charge high prices and thus exploit the consumers. Also, the big businesses control many types of businesses and industrial concerns at the same time. Hence, there is lot of concentration of economic power in a few hands. The concentration of economic power is considered to be one of the major defects of capitalism.

(ix) **Malpractices.** In recent years, the image of capitalism has been tarnished by sharp practices (or malpractices) indulged in by big industrialists and businessmen. Such practices include payment of handsome salaries to influential directors, the large-scale evasion of fiscal laws, luxurious living at nation's cost and persistent generation of black money through clandestine deals and surreptitious transactions. The seamy side of capitalism has been thoroughly exposed by the scandals circulating about the big business personalities. For example, the recent Lonrho affair rudely shook the U.K. by the misdeeds of the British mining and trading tycoons. In a debate in the House of Lords, even Prime Minister Edward Heath conceded that the malpractices "constitute the unpleasant and unacceptable face of capitalism." The labour peers warned that the system was "so uncivilised that it gravely imperilled the future."

Conclusion. These few points constitute a sufficient indictment on the present system. Ruthless exploitation of women and children, callous disregard of the aged, the sick and the unemployed, and the mercenary motives mainly governing human relations have all pricked the social conscience, and people are furiously looking round for an alternative. Already, the death-knell of capitalism has been tolled over a large part of the globe. People now proudly put forward their progressive views in capitalist countries. As an escape from the intolerable conditions prevalent under capitalism, the chief alternatives suggested are: Planned Capitalism, Socialism and Communism. In the meantime, the governments of capitalistic countries are taking active steps to remove the glaring defects of capitalism like economic instability, unemployment, economic inequalities by adopting appropriate fiscal and monetary policies and by converting themselves into welfare states.

CHANGING FACE OF CAPITALISM: TOWARDS THE WELFARE STATE

Capitalism has shown wonderful vitality, resilience and adaptability to changing circumstances and situations. No wonder that it has not merely survived but has been flourishing and it has belied the hopes and fears of those who predicted its disintegration and doom. What is remarkable is the swift transformation which has come about in the structure of capitalism, and the welfare state has emerged as an aspect of capitalism. This is a self-corrective step. The liberal constitutional tradition which built capitalism is now moulding it into a concept of welfare state.

What is a Welfare State?

"The welfare state is a form of society characterised by a system of democratic, government-sponsored welfare placed on a new footing and offering a guarantee of collective social care to its citizens, concurrently with the maintenance of a capitalist system of production". (Piet Thoenes). It is a system which guarantees to the citizens freedom from want and fear. It looks after him from the cradle to the grave, meeting all his vital and reasonable requirements in the matter of education, health, housing, employment, old-age pensions, etc. It takes off all his wordly worries as it were. Welfare State may also be defined as under—

"A civil community in which the instrumentalities and the authority of government are employed to establish, maintain and guarantee to its citizens certain specific conditions of physical and sociological protection, beneficial services, and institutionalised opportunities that are considered to be essential to general public welfare of the State and to the corresponding personal well-being of each citizen."[1]

This is the direction in which modern capitalism is moving. It was due to Keynes's strong advocacy of State intervention and expansion of State activities that this social revolution was brought about.

In England, the National Insurance Act of 1946 provides to every one in the country sickness benefit, guardians' allowance, death grant, maternity benefits, widows' benefits, un-employment benefit, etc. Now children attending school run by local authorities do not pay any fees and they get books and equipment free. They are also provided milk during school hours free. Meals and milk on a modest scale are provided in India too. A number of social security measures are on the statute book e.g. Employees' Provident Fund, Maternity Benefit Act, Employees State Insurance Scheme, Social Security for Old and Disabled, Family Pension Scheme, Pension for widows. It is, however, a far cry from the comprehensive social security provided in the west.

Thus the transformation of capitalism to a sort of welfare capitalism is the most remarkable development of modern times. It is due not only to the working of democratic forces in the State, but what is important to note is, that several capitalist enterprises have introduced welfare schemes for their workers.

1. Perspectives on the Welfare State edited by S. P. Aiyar, 1966, p. 133.

68 SOCIALISM

Definition

Socialism, as an alternative to capitalism, has the widest appeal. A Swedish king once remarked to his minister, "If one is not a socialist up to the age of twenty-five, it shows that he has no heart; but if he continues to be a socialist after the age of 25, he has no head". Socialism seems to have caught the imagination of youth all the world over.

For a long time, the definition of socialism as given by the Webbs was accepted by a majority of the socialists. Their definition runs thus: "A socialised industry is one in which the national instruments of production are owned by public authority or voluntary association and operated not with a view to profiting by sale to other people, but for the direct service of those whom the authority or association represents". This definition does not correspond to the present notion of socialism, because it does not imply any idea of planning.

The definition given by Dickenson seems to be better. According to him, socialism is an economic organisation of society in which the material means of production are owned by the whole community and operated by organs representative of, and responsible to, the community according to a general plan, all members of the community being entitled to benefits from the results of such socialised planned production on the basis of equal rights.[1]

According to another definition which brings out the implications of socialism more clearly, "Socialism refers to that movement which aims at vesting in society as a whole, rather than in individuals, ownership and management of all nature-made and man-made producers' goods used in large-scale production to the end that an increased national income may be more equally distributed without materially destroying the individual's economic motivation or his freedom of occupational and consumption choices."[2] In Morrison's words, "the important essentials of socialism are that all the great industries and the land should be publicly or collectively owned, and that they should be conducted (in conformity with a national economic plan) for the common good instead of private profit.[3]

There is no complete agreement as to what socialism exactly is. It seems there are as many types of socialism as there are socialists. Socialism has been compared to a hat which has lost its shape because everybody wears it. It has been aptly remarked that "Socialism has been called many things and many things have been called socialism."

The kaleidoscopic nature of socialism has been described by Shadwell thus:[4] It is both abstract and concrete, theoretical and practical, idealist and materialist, very old and entirely modern; it ranges from a mere sentiment to a precise programme of acting; different advocates present it as a philosophy of life, a sort of religion, an ethical code, an economic system, a historical category, a judicial principle, it is a popular movement and scientific analysis, an interpretation of the past and a vision of the future, a war cry and the negation of war, a violent revolution and a gentle revolution, a gospel of love and altruism, and a campaign of hate and greed, the hope of mankind and the end of civilisation, the dawn of the millennium and a frightful catastrophe." How paradoxical!

From the definitions given above, we are in a

1. Dickenson, H.D.—*Economics of Socialism*, 1939, p.

2. Loucks and Weldon Hoot—*Comparative Economic Systems*, 1948.

3. *Readings in Economics*, edited by P.A. Samuelson, Second Edition, p. 430.

4. *The Quarterly Review*, July 1924, p. 2.

position to understand the basic idea/ideas underlying socialism. In simple words, socialism implies social ownership of means of production. But besides social ownership of instruments of production, socialism implies several other things. It implies equality of incomes and equality of opportunity for all. Socialism does not mean that all productive resources should be owned by the State, only the major instruments of production should be under the State control so that economy is run for social benefit rather than private profit. Socialism wants to change the old capitalistic structure of society and replace it by a new economic order based on equality and social justice. Instead of special prerogatives and vested interests, socialism lays emphasis on work and ability and equal opportunities for all regardless of caste, class and inherited privileges.

Authoritarian Socialism *versus* Liberal Socialism

It may be instructive to distinguish between two types of socialism: (a) Authoritarian Socialism, and (b) Liberal Socialism. In authoritarian socialism, State ownership covers all the means of production and allocates them by planning for the production of various goods. In this system, there is no sovereignty of the consumer nor any freedom for the labour to organise themselves. What to produce, how to produce and how is output to be distributed, how much is to be invested for economic development—all these decisions are made by the government. This authoritarian socialism is generally called communism which is prevalent in countries like Russia and China.

On the other hand, under **Liberal** Socialism, the government takes up the ownership of the means of production, but the price system or market mechanism is retained. The consumers are given the choice of consumption. The managers of factories appointed by the government produce commodities considering the consumers' demands and the prices of the factors supplied by the government. The concept of Liberal Socialism has been propounded by the economists like Dickinson, Lange and Taylor.

MARXIAN SOCIALISM

Karl Marx, who wrote in 1867 his famous book **Das Kapital**, the Bible of socialism, is considered to be the father of scientific socialism. He tried to put the theory of socialism on a scientific basis. His theory led him to the conclusion that capitalism was doomed to decay.

Main Elements in Marxian Theory

The chief points of the Marxian theory are discussed below:

(i) **Materialistic Conception of History.** Karl Marx seeks to explain every event of history on economic ground. He gives an economic interpretation of history. All wars, riots and political movements have their origin in economic factors. There is an appropriate political organisation, corresponding to every economic stage. A capitalist economy, for example, will evolve a system of government which perpetuates and supports property rights.

He goes on to explain how capitalism will generate conditions which will replace it by socialism. The capitalists will grow in wealth as time passes, but will become fewer and fewer, the bigger whales swallowing the smaller ones. Monopolies will be created, production will expand necessitating scramble for markets abroad. This will lead to an imperialist war, and one war will be followed by another more terrible than the preceding one till capitalism perishes in the conflict, and the dictatorship of the proletariat is established.

(ii) **Labour Theory of Value** According to Karl Marx, value represents the human labour used in production. In other words, the value of a commodity depends on the labour used in the production of that commodity. It is equal to the socially necessary labour time. Marx defined value of a commoditty "as the labour time required to produce an article under the normal conditions of production and with the average degree of skill and intensity prevalent at the time."[5]

Karl Marx has given the same definition of capital as Ricardo has defined it on the basis of past labour. As for differences in quality of labour, he considered efficient labour as a form of intense labour. According to him, a given quantity of skilled labour is equal to a bigger amount of ordinary labour. He said this deficiency is continuously being made good. Whatever may be the amount of skilled labour used in the production of a commodity but if it is equated to a commodity produced by ordinary labour, its price will represent only a given quantity of ordinary labour. According to Marx, the ratio of skilled labour and unskilled labour is fixed by convention. In his view, skilled labour is more valuable because, as compared with unskilled labour, it requires more time and labour.

(iii) **Theory of Surplus Value and Exploitation.** Marx propounded his theory of surplus value on the basis of his theory of value. He said that in order to enable labour to carry on the work of production, he should have some instruments of production and other facilities but he lacks these facilities. Hence, he has to sell his labour to the capitalist. It is, however, not necessary for the capitalist to pay labour the full value of the product produced by him. Here Karl Marx supported his theory on the basis of a

5. *Capital*, Vol. I Chapter I, Sec. I.

classical theory, *viz.,* the subsistence theory of value according to which the level of wages is determined by the subsistence of the worker. What happens is that a worker continues working even after he has earned sufficient amount of money for his subsistence. That is, he continues working even beyond the time when he has put in labour worth its price. Sometimes he works for 12 hours, whereas six hours' labour was enough to compensate the capitalist. Thus, work of labour force is not merely to produce value equal to its price but much more. This surplus value is the difference between the market value of the commodity and the cost of the factors used in the production of the commodity. Karl Marx says that the manufacturer gets for his commodity more than what he has spent on labour and other costs. The excess of market value over the costs is the surplus value. By using this surplus value, the capitalist can get still more surplus.

This surplus is the creation of labour. It is created because labour is paid much less than is due to it. He characterises the appropriation of the surplus value by the capitalist as robbery and exploitation. A commodity, according to him, is simply 'crystallised labour' or 'congealed labour'.' In this way, the capitalist class goes on becoming richer and richer through exploitation of the working class. Thus, Karl Marx propounded his theory of exploitation on the basis of the theory of surplus value.

(iv) **Capitalist Development and its End.** According to Karl Marx, the forces that operate in the capitalistic system lead to greater and greater exploitation of labour. The capitalists compete against one another to increase their profits. Like Ricardo, Karl Marx asserted that in the long run wages have a tendency to fall to the minimum subsistence level. In other words, according to Marx, excepting in the short run, wages do not exceed the subsistence level. But the reason put forward by Marx for the wage being equal to subsistence level are different from those given by Ricardo. According to Ricardo, wages keep to the subsistence level owing to increase in population. But according to Marx, it is the excess of current supply of labour over demand that prevents the wages from rising above the subsistence level.

Since the supply of labour continues to be in excess of the demand for it, there is always in existence a large supply of labour which Marx calls the reserve army of labour. Hence, it is this large reserve army of labour (*i.e.*, mass of unemployed labour) which prevents wages from rising above the subsistence level. The supply of labour exceeds the demand for it because the capitalist entrepreneurs are unable to absorb all the labour rendered jobless by the destruction of handicrafts or when the precapitalist entrepreneurs are displaced by the capitalist entrepreneurs owing to lower per capita productivity in the pre-capitalist period. So long as the capitalist entrepreneur flourishes at the expense of the pre-capitalist entrepreneur, the supply of wage earners exceeds the demand for them.

Owing to wages continuing at the subsistence level, the techniques of production which increase productivity also increase the rate of exploitation. In this way, the profits of the capitalists go up. According to Marx, the capitalists, who are owners of the physical means of production, compete against one another so that they may be able to raise the rate of exploitation and thus maximise their profits. That is why Prof. Patterson has said that in the Marxian theory, competition among the owners of physical means of production for increasing the rate of exploitation or the non-wage share takes the form of a conflict or struggle.

There are three ways of increasing the rate of exploitation or the surplus value: (a) to increase the rate of exploitation by increasing the length of the working day. When the working hours are increased, total output increases, but wages being fixed, the rate of exploitation increases or the profits extracted by the capitalists increase. (b) surplus value or the rate of exploitation is increased by the more intensive use of labour. The working hours are not increased but the workers are made to produce more. But the surplus value cannot be substantially increased by these two methods; (c) according to Marx, there is a third and more important method of increasing surplus value, *viz.*, to increase the physical productivity of labour by technological progress. Technical progress implies improvements in techniques of production by which labour is able to produce more, working the same number of hours as before or working with the same intensity as before. The result is that the total output of labour increases. Since wages continue at the subsistence level, the margin between the subsistence output and the improved technique output widens. In this way, there is increase in surplus value or the rate of exploitation.

But technical progress can be achieved only through the accumulation of capital. The result is that there is keen competition among the capitalists to accumulate capital. But in the Marxian system, as Kaldor says, the accumulation of capital is done not for the lure of profit but it is thrust on the capitalists by the competitive struggle among them.

Thus, discussing the hidden motives of capital formation, Kaldor observed that Ricardo explained it as arising from the desire for higher rate of profit. The capitalists of their own desire accumulate capital so long as the rate of profit from the productive use of capital is more than the minimum required for risk-taking. For Marx, capital accumulation by capitalist entrepreneurs is not a matter of their own choosing but a matter of necessity. This is

due to a keen competition among the capitalists themselves. This has been explained with the help of economies of scale. There is an implicit assumption that capital used by a particular capitalist is governed by his own accumulation. Considering the fact that larger the scale of operation, the more efficient will be his production, every producer is automatically led to an increase in his scale of output by the reinvestment of his profits. He does so because he does not want to lag behind in the competitive race.

Thus, we see that owing to technical progress and stepping up of capital accumulation as capitalism develops, the rate of exploitation or suplus value of labour increases on account of competitive struggle among the capitalists. Consequently, as capitalism develops, the national income will rise but the relative share of wages (*i.e.*, share of labour) will fall and the relative share of profit (or the share of the capitalist) will go up.

Thus, the working of capitalistic system results in the worsening condition of the working class. Marx has called it the law of increasing misery of the working class. According to this law, owing to technical progress, increase in capital accumulation and the consequent increase in national income under capitalism, the relative share of wages in national income is bound to fall and that of capital is bound to go up.

It is thus clear that the conclusion at which Marx arrives regarding the changes in the relative shares in the national income, owing to the development of capitalism, is contrary to that of Ricardo. Ricardo thought that with the development of capitalistic economy, the relative share of wages in the national income would rise whereas the share of profits would decline.

Prof. Patterson has rightly remarked that in the Marxian model of income distribution, the fundamental reason of the decline in the relative share of wages is technical progress, the full benefits of which go to the owners of physical means of production. The increasing hardship of the working class is not due to the declining level of real wages because, in absolute terms, their hardship is not aggravated. The reason is that there may not be any increase in real wages along with increase in productivity, yet there is no decline either. This is the essence of Marxian theory of distribution. Although Marx came to the conclusion that, on the development of capitalism, the relative share of profits will increase owing to technical progress and the accumulation of capital, but following Ricardo, he too accepted the view that owing to the accumulation of capital the **rate of profit** would decline. It may be specially noted that according to Marx on the development of capitalistic economy when the **relative share** of profits goes up there is a fall in the rate of profit. It looks paradoxical but Marx fully explained the co-existence of these two trends, *viz.*, the share of profit and the rate of profit. But Marx did not explain the declining rate of profit with the help of the law of diminishing returns which Ricardo had emphasised. Instead, Marx explained the declining rate of profit on the basis of an increase in the organic composition of capital.

Surplus value is basic for profits and accumulation. The aim of the capitalist is to increase surplus value to the maximum. At first, when the supply of labour is large, wage rate remains constant at the subsistence level, but sooner or later, the demand for labour exceeds the available supply and wages rise, reducing thereby surplus value. With the loss of surplus value, there is a 'crisis', as the capitalist has no incentive to invest. He also tries to create again a surplus of labour by using labour-saving machinery but this also is temporary solution as a too frequent resort to this device will lower the rate of profit and thereby reduce the capitalists' incentive to accumulate.

Thus, capitalism is doomed to fail and give place to socialism. This is the picture which Marx himself gives of the end of capitalism; "Along with the constantly diminishing number of the magnates of capital, who usurp and monopolise all advantages of this process of transformation, grows the mass of misery, oppression, slavery, degradation, exploitation; but with this too grows the revolt of the working class, a class always increasing in numbers. and disciplined, united, organised by the very mechanism of the process of capitalist production itself . . . . centralisation of the means of production and socialisation of labour at last reach a point where they become incompatible with their capitalist integument. This integument bursts asunder. The knell of capitalist private property sounds. The expropriators are expropriated".[6]

Criticism of Marxian Theory

Marx has proved to be a poor prophet of future events. Some of the predictions of Marx have proved to be true while others have proved wrong. His prediction regarding the increasing hold of monopoly has been proved to be true by later events. But his other prediction regarding continuous misrey for the working class under capitalism has proved to be wrong in countries where capitalism has been successful. In countries of Western Europe and the U.S.A. the standard of living of the worker has been steadily rising and not falling.

He had predicted that the relative share of wages in the national income would decline and the economic condition of the workers would deteriorate. But this has not happened. Emperical research has shown that in the countries in the pre-capitalist

6. *Readings in Economics* edited by P.A. Samuelson and others, Second Edition, p. 420.

stage, labour's share in the national income has remained consant and, as Marx had said, there has been no decline in this share either. In the capitalist countries, labour has got sufficient share in the increase in physical productivity which has taken place on account of technical progress and capital accumulation. As a result, there has been marked improvement in the living conditions of workers. That is why they are now less revolutionary than before.

Besides, there is no evidence of decline in the rate of profit. It is in view of the declining rate of profit and concentration of purchasing power in the hands of a few people that Marx had predicted that capitalism would face crises off and on, and capitalism would utlimately come to an end. The actual events have falsified the gloomy predictions of Marx. It is true that trade cycles keep recurring in the capitalistic economies. But in spite of short-term ups and downs, the capitalistic economies made a very rapid economic progress in the first 100 years and it is on account of this that these countries became affluent. Prof. Patterson has rightly remarked that Marx had thought that capitalism would rapidly disintegrate on account of ever recurring serious crises and it would finally and completely end on account of revolution by labour, and communism would be ushered in this way. Marx had not only wrongly predicted about the behaviour of labour's share in national income but also about the long-term development of capitalism.

Moreover, there are several theoretical flaws in the Marxian theory of declining rate of profit as a result of a change in organic composition of capital. Some writers have said that the law of declining rate of profit cannot be derived from the law of increasing organic composition of capital. Since Marx assumed that the real wages of labour remained stable at the subsistence level, there will be great increase in per capita productivity as a result of increase in the organic composition of capital owing to capital accumulation and technical progress. The rate of profit will also increase on account of real wages remaining constant at the subsistence level and rapid increase in the surplus value earned by the capitalists. It is worth noting Prof. Kaldor's views in this connection. He says: "Since, Marx assumed that the supply price of labour remains unchanged in terms of commodities, when the organic composition of capital and hence output per head rises, there is no more reason to assume that an increase in organic composition will yield a lower rate of profit than a higher rate. For even if output per man were assumed to increase more slowly than ("constant" plus "variable") capital per man, the "surplus value" per man (the excess of output per man over the costs of reproduction of labour) will necessarily increase faster than output per man, and may thus secure a rising rate of profit even if there is diminishing productivity to successive additions to fixed capital per unit of labour."[7]

Finally, Marx's theory of income distribution is based on the labour theory of value which is not accepted by modern economists. Marxian analysis of surplus value or the exploitation of labour is obviously based on the concept that aggregate value is produced by labour, and capital only transfers its value to the value of the commodity. Capital makes a significant contribution to productivity and substantially adds value. To deny this is only to show one's bias. Besides, the labour theory of value is only a form of the cost of production theory. As Marshall had said long time back, only costs of production (cost of labour together with cost of capital) do not determine value. Price of a commodity also depends on its marginal utility or demand for it. The price of a commodity is determined by the interaction of the forces of demand and supply. Hence, Marx's view that the value of commodity is determined by that labour time which has been used in making it is wrong and the modern economists do not accept it. Thus, if the labour theory of value is wrong, the theory of surplus value or theory of exploitation based on it is also proved to be wrong.

SOME OTHER FORMS OF SOCIALISM

Collectivism or State Socialism

The collectivists or the State socialists believe in parliamentary democracy and nationalisation of the means of production. They want to capture the political machinery, strengthen it and use it for the realisation of the socialists' aims and ideals. The powerful State engine is to be utilised for the production of wealth and its equitable distribution. State is to be all in all, and as soon as the socialists have captured it, they have reached the goal. The State will do for them all that they want. Private enterprise will be put an end to. All production will be carried on by salaried State officials and profits will go to the State coffers and utilised for the uplift of the masses.

The only difference between capitalism and State socialism is that under the latter, means of production are owned and managed by the State instead of the private entrepreneur, otherwise the exchange mechanism of capitalism, *e.g.*, pricing, marketing, *etc.*, is retained.

Among the chief tenets of the socialist creed may be mentioned (a) State ownership of productive resources, (b) redistribution of national income.

7. Robinson, Joan—*An Essay on Marxian Economics*, pp. 75–80 and N. Kaldor—*Alternative Theories of Distribution*.

(c) economic planning, and (d) peaceful and democratic evolution of the economic system.

Guild Socialism

The guild socialists have no faith in the State running economic activity. Unlike the collectivists, the guild socialists do not believe that the State can successfully use the productive resources of the community. According to the guild socialists, it is necessary to do away with the private capitalists. But they want the business organisations, factories and productive resources, *etc.*, to be handed over to labour organisations for management and operation. In their view, guilds of the workers can best run them. They want to put industries under the administration and control of these guilds. They want the State merely to supervise, fix prices and look after the quality of the products and thus safeguard the interests of the consumers.

The basic principle is that the means of production should be under the ownership of the State but the actual implementation of this ownership should be in the hands of the workers. The State should only see that the consumers are not exploited or cheated. The aim of the guild socialists is to avoid the evils of excessive concentration of power and inefficiency of bureaucracy in running the economic activities. They claim that according to their system decentralisation will usher in real democracy in the world and improve the working capacity of industries.

Syndicalism

The syndicalists too, like guild socialists, do not consider political power as an appropriate weapon for the achievement of socialist aims. Whatever the type of political authority, it invariably has special type of bureaucratic tendency. It can never understand the aspirations of the workers. It has a bad habit of dominating over others. Hence, according to the views of the syndicalists, if the State is made all powerful, it will produce many petty tyrants. That is why the syndicalists want to build up social, political and economic structure on the foundation of trade unions.

They have no faith that they can achieve their aims through constitutional means. They know that political authorities are very powerful. Hence, they (*i.e.*, the syndicalists) believe in direct and violent action. Strike is their main weapon. They believe that even if the strike is unsuccessful it gives the workers an experience in economic warfare. Through strikes, the workers become more strongly organised and their hatred for the capitalists becomes more bitter and this hatred should not be allowed to diminish. Their strategy is that there should be strike after strike and a long strike in the end to paralyse the administration and capture power. The syndicalists lay great stress on the destruction of existing economic and political structure. They deliberately do not throw any light on the structure of society which they propose to create after the revolution. Their policy is that of destruction rather than construction.

Communism

The Communist Manifesto of 1845 lays down the strategy that the communists want to adopt for the achievement of their aims. The communists lay stress on the formation of a network of communist organisations all over the country and the world, capturing key posts in other organisations and carrying on their work silently adding to the number of adherents. When the party has become sufficiently strong, it attempts to capture government machinery and lay the foundation of the proletariat State. The State machinery is utilised to crush all opposition and to expropriate the capitalists. The aim is to create a classless society where there is no distinction of high or low, rich or poor. When the objective is achieved, the State is considered unnecessary. It will 'wither away'.

As for the type of society which the Communists envisage, some idea can be gathered from Plato's *Republic* or Well's *New Worlds for Old.* The Communists propose to abolish all forms of private property, not merely in the instruments of production but also in the consumers' goods. Those consumers' goods which are intimately connected with the person of the consumer, *e.g.*, food and clothing, are transferred to individuals and families and those which are not so connected, *e.g.*, houses, are owned by society, only their services are transferred to the consumers.

People are supposed to work according to capacity and get according to need. Everybody is to be assigned a definite job. He cannot choose his own occupation. Nobody will have a house of his own or a bank account. Everyone will be a government employee; he will not be paid cash but he will get his meals in the State kitchens and live in Government quarters. He will be provided commodities and services for consumption not of his choice but what the State chooses to give according to production at the time. The bringing up of the children, their education and employment, will be the State concern. The pricing system will disappear. The State will control production, assign jobs, fix remuneration and prices of goods and services without profit motive. A very alluring dream indeed! It is utopian.

In the communist society, there will be no trade cycles or unemployment nor can there be differences of the rich and the poor. The conflict between labour and capital will disappear. **This view is undoubtedly imaginary and impractical.** In the beginning, the Russians tried to implement these

ideas. They abolished money and exchange. But it did not work. The money economy had to be re-established. In order to provide incentives for efficiency and good work, different wages had to be offered.

Anarchism

The ultimate aim of the communists is to build a social structure in which there will be no need for the State. As we said above "the State will wither away." This is technically known as anarchy. In ordinary language, anarchy means absence of government rule and disorder. But in the socialist phraseology it simply means 'statelessness' when the administration has become superfluous and the society regulates itself but there is no disorder. The communists believe that when capitalism has come to an end, all greed, selfishness, cheating, tyranny, *etc.*, generally associated with capitalism will disappear from the world and in their place will be established virtues of self-sacrifice, social service, goodwill, *etc.* Instead of grabbing, the people will adopt an attitude of sacrificing for others. Man will have been so much uplifted then, that there will be no need for the police. The courts will be closed. Is it not surprising? Fahien tells about the ancient Indian society that there were no thefts and no robberies and people did not lock their houses. It is possible that sometime the anarchists' dream may come true.

The economic and social life will be organised into self-regulating or self-governing institutions. All the functions of the State will be automatically carried out. Every individual will respect the rights of others and there will be no difficulty of any type. The State will be like an automatic traffic signal. When the policeman is off the traffic duty, the traffic regulates itself. This is how the society will itself regulate its affairs in the absence of a government. This is another sweet dream. We get an outline of this plan from Prince Kropotkin. The anarchists say that government is needed only to protect the unjustly obtained wealth, undue profits and loot of the capitalists. When capitalism goes, the government will follow suit.

Fabian Socialists

Fabian socialists are men of literature. Bernard Shaw was one of them. They sincerely believe that socialism is a question of conviction. If the people can only be convinced of the virtues of socialism, no power on earth can prevent its coming about. Through literary propaganda—novels, dramas, short stories- they expose the evils of capitalism and bring out the merits and necessity of socialism. It is hoped that, in course of time, the world will come to believe in socialism, and socialism will then come to prevail. They may not be wrong.

GENERAL FEATURES OF SOCIALISM

Although there is a great diversity of views among the socialists and there are as many types of socialism as there are socialists, yet it is possible to pick up a few general features of socialism.

(i) **Social Ownership of Means of Production.** The socialists believe in the abolition of private ownership in the instruments of production. Land, factories, railways, mines and every other means of production must be nationalised. Their ownership and control are to be vested in the State so that the State may provide work for everybody.

Socialisation of the means of production is so important a characteristic feature of socialism that some writers define socialism as social ownership of the means of production. The means of production are the property of the State and not of private individuals. The profits of all enterprises go to the State exchequer to be utilised for the benefit of society rather than for the benefit of a few private individuals.

But it may be mentioned that it is not necessary to nationalise all means of production to bring about socialism. Generally, it is considered sufficient and useful to nationalise only the principal means of production like heavy and basic industries, mines, banks, means of transport like railways, motor transport, *etc.* However, State control-extends over all means of production and the entire economy to make sure that the economy functions to promote the interests of the society as a whole. So far as land is concerned, the actual tiller or a co-operative society can be given the ownership. In fact, 'land to the tiller' is the principal objective of socialism. Several other land reforms are introduced so that the tiller is actually made the owner of land and he gets a proper reward for his labour. Besides, the farmers are encouraged to form co-operative farming societies so that large-scale farming can be undertaken.

(ii) **No Private Enterprise.** Generally, there is to be no private enterprise. Production is to be initiated and conducted by the State which will pay wages and other costs and keep profits to itself. Interest and rent as payments respectively to the capitalists and the landlords will disappear, for the State will be the capitalist, landlord and entrepreneur. However, in agriculture, as mentioned above, co-operatives may be permitted.

(iii) **Economic Equality.** Living on unearned income is to be discouraged. Remuneration for work is to be according to the nature of work and is not to be equal. Earnings will vary according to ability. A limited operation of the law of demand and supply in this connection is envisaged.

There is, thus, no basis for the belief that under socialism all would be equal economically. No

economic equality is guaranteed. But there are to be no glaring inequalities. All possible steps are taken to reduce economic inequalities of income and wealth. Since industrial and business enterprises belong to the State, there is little possibility of amassing wealth by private individuals. In other words, perfect economic equality is not the aim of socialism. However, it aims at social justice in the distribution of national income. It, therefore, aims at giving a fair share to all in the national income. Some inequality in incomes is considered essential to provide incentive for harder and better work. Unless efficient workers are paid better no one will try to be efficient in his work. Hence, workers will not fully use their skill, ability and experience unless they are better rewarded. Thus, in case of perfect equality of incomes, national output will go down and the nation is bound to suffer. The national economy will suffer in performance if income equality is insisted upon. Thus, instead of perfect equality of incomes, the socialists aim at minimum practicable inequality. As Douglas Jay observes, "Basic aim of socialism is not literal or absolute equality but the minimum equality that is workable if human beings are actively to use their talents, not equal shares but fair shares, not perfect equality but social justice." System of inheritance which leads to unearned incomes is not permitted. Those factors of production, *e.g.*, land, capital which can yield unearned incomes are nationalised. But interest on savings given to the government is permissible.

(iv) **Equality of Opportunity.** Although, as we have said above, socialism does not guarantee perfect equality of income. it aims at providing equality of opportunity. In fact, to provide equality of opportunity is a basic objective of socialism. Every individual, whether he belongs to a rich family or a poor family has an equal opportunity to rise in life under socialism. Every young person is given equal opportunity to receive education or training according to his aptitude so that he can enter a profession of his choice. Children of poor parents have to face lot of difficulties in life. The poor parents are not in a position to provide their children basic minimum means to equip themselves mentally or physically for life. They have no resources at their disposal to give the necessary education and training. Either they cannot afford to send their children to school or they have to withdraw them from the school early to supplement their income by putting them to a job. The inequality of opportunity starts from the birth itself. The atmosphere in which these children are brought up is suffocating and causes them intense worry. The socialist society does not tolerate it.

Under socialism such steps are taken that every child, whatever his family background, gets full opportunity to develop his inborn and latent faculties. To ensure equal opportunities for all, it is essential to provide free education and health services up to the secondary standard. At the university level also, it is essential to provide talented students a scheme of stipends and free ships. All these things are provided under a socialist regime.

(v) **Economic Planning.** The State is in charge of both production and distribution. The allocation of the productive resources of the community will be determined according to the direction of a central authority. In fact, economic planning is an essential feature of socialism.

Economic planning is most closely associated with the Russian system. Although now for some years, economic planning has been adopted by capitalist countries too, yet it cannot be comprehensive and effective as under socialism, because under capitalism the means of production are under the control of private individuals and the direction of production and of productive resources is done through price-mechanism. There can be only indicative planning or planning by inducement under capitalism which does not prove so effective. Since under socialism, the principal means of production are owned and controlled by the State, it is possible to direct the production of commodities and the utilisation of resources in the desired channels. If it is desired to use the productive resources effectively and to produce a certain set of commodities, economic planning is essential for socialism.

Under socialism, the place of price-mechanism is taken by planning commission which is entrusted with the work of laying down the objectives of planning and to settle the targets and priorities of planning. The planning commission formulates five-year plans for economic development which are implemented through the various governmental agencies.

Economic planning ensures speedy economic development. It ensures efficient and optimum allocation of resources. In the underdeveloped countries, where without raising the level of national income and wealth, socialism cannot be brought about, economic planning is absolutely essential for socialism, because without it the level of production cannot be raised.

But under socialism, only increase in production is not considered sufficient. The objectives of socialism is also to ensure a fair distribution of gains in production and income. Hence, economic planning is required for socialism not merely to accelerate economic development but also to ensure a fair distribution of fruits of economic growth. In pursuance of the socialist objectives, economic planning in India is not only to raise the level of national income but also to reduce economic inequalities and to prevent concentration of economic power.

(vi) **Social Welfare and Social Security.** Another important feature of socialism is that it is social welfare consideration which guides productive acti-

vity in the economy rather than private profit. Under capitalism, only production of such commodities and services is undertaken whick are expected to yield maximum profit. It follows, therefore, that under capitalism, luxury goods are produced for the rich rather than goods of mass consumption required by the poor. The poor are thus deprived of the necessaries of life while the rich are enabled to lead a luxurious and wasteful life. This is so because production of luxuries is more profitable than the production of necessaries of life. In this way, profit motive is the determining factor of economic activity under capitalism. But situation is entirely different under socialism. Commodities and services of such type and in such quantities are produced which are essential for promoting social welfare. The motive power of economic activity under socialism is social welfare and not private profit. The work which is performed by market mechanism under capitalism is performed by central economic authority under socialism, which determines and guides all economic activity. Planning Commission keeps social welfare uppermost in consideration.

Under socialism, the State devotes its attention to ameliorating the lot of the common man by providing him and his family with adequate medical aid, full and free education and ample means of recreation and entertainment. Freedom from want is guaranteed and fear, born of insecurity, is to be banned.

(vii) **Classless Society.** The socialists believe in a classless society where the distinction between the rich and the poor and the 'haves' and the 'have-nots' has completely disappeared. Thus, the caste system that prevails in India is repugnant to socialists. In a socialist State, every individual enjoys equality of opportunity regardless of caste, creed, family and religion. A socialist state is really a secular state.

The prime objective of a socialist State is that the society is not divided into two classes of labour and capitalists as under capitalism. That is why big zamidars and capitalists have no place under socialism. Severe restrictions are imposed on the control and ownership of private wealth. Every individual gets a reward according to his work and ability. It is in this way that class-conflict, which prevails under capitalism, is put an end to under socialism and a classless society is created.

CASE FOR SOCIALISM

The evils of capitalism have given birth to socialism. Socialism has started as a reaction to industrial revolution that took place in the Western European countries. The industrial revolution of the Western European countries made some people very rich in the midst of poverty elsewhere. It resulted in the exploitation of labour, women and children by the capitalists. Above all, capitalism failed to maintain economic stability. Periodically, the capitalist economy is engulfed in depression which is responsible for large-scale unemployment of, and hardship to, millions of people. Also, capitalism has given rise to extreme inequalities of income and wealth. The poor were deprived of social justice. Owing to the domination of the individual profit motive, the capitalistic economy witnessed a serious misallocation of resources. Socialism seeks to rectify all these evils and create a just social order. Socialists claim the following merits for their system:—

(i) **Social Justice.** The chief merit of socialism is that it assures of social justice. Under socialism, the inequalities of income are reduced to the minimum and the national income is more equitably and evenly distributed. The socialist principle provides for a fair share for all. No one is permitted to have unearned income. Exploitation of man by man is put an end to. Every individual is assured of equal opportunity to develop his latent faculties through proper education and training.

(ii) **Better Allocation of Resources.** As compared with capitalism, the productive resources of the nation are more economically and optimally allocated among the various productive uses. Owing to extreme inequalities of income and the existence of monopolies in the industrial sector, capitalism is incapable of a rational and economical allocation of the productive resources of the community. Besides, private entrepreneurs do not take into consideration social costs while deciding about the allocation of resources. As a result, the productive resources of the community are misallocated.

On the contrary, under socialism a central planning authority determines the allocation of resources among the various uses whose sole aim is to promote social welfare and social security. A planning authority is in a better position to assess the basic needs of the people and the intensity of their desires and to devote the resources to satisfy these desires and meet these needs in the best possible manner. It is wrong to say that socialism completely ignores consumers' preferences and demand for the various commodities and services. In a socialist economy, State can fix the prices of finished goods and give to the consumers a free choice of the goods available in the market at fixed prices. The consumers' demand and preferences can be estimated from the purchases made by them in the market and resources can be devoted to the production of commodities accordingly. But there is no harm also in ignoring certain desires of the consumers if they conflict with social welfare. Often a consumer is unable to understand what is best for him.

Hence, the planning commission under socialism has to strike a desirable balance between social welfare considerations and the individual

consumers' preferences. Thus, the allocation of resources under socialism proves to be much better and more rational. In the allocation of resources, due consideration is given to human wants, consumers' preferences and social costs.

(iii) **Rapid Economic Growth.** Another important benefit of a socialist State is that it promotes rapid economic growth. The task of promoting economic growth is not left in the hands of free private enterprise or market mechanism. The free private enterprise and the market forces cannot ensure rapid economic growth. A socialist State adopts economic planning as a means of promoting rapid economic growth. Economic planning makes it possible to use potential productive resources in the most effective and fruitful manner and in this way ensures rapid economic growth. A free market economy functions in a defective planless and disorderly manner. As against this, a planned socialist economy functions right according to the programme and in a systematic and orderly fashion and marches rapidly on the road to economic progress. The rates of saving and investment can be raised by economic planning which are absolutely essential to accelerate economic growth. In the words of late Pt. Jawaharlal, "it is only through planned approach on socialistic lines that steady progress can be attained."

(iv) **Improving Productive Efficiency.** Another important merit of socialism is that under it national output can be significantly increased. This is due to the fact that under socialism, the production is undertaken to increase social welfare and not for the benefit of any particular individual. Under socialism, improved techniques of production and scientific research are made freely available to all organisations that may need them. On the other hand, under capitalism, improved production techniques and results of scientific research, which are known to certain firms, are generally kept absolutely secret so that the competing firms cannot avail themselves of them. And what is more, the monopoly concerns under capitalism limit their output so that they may raise the prices of their products in order to increase their monopoly profits. This means that their output is below the welfare level. But this cannot happen under socialism because none can benefit from the policy of reducing output. All major industries are under complete social control and they are run for social benefit. It is quite clear that the society cannot benefit by reducing output, for the reduction of output means reduction of national income and so of social welfare.

Under socialism, production techniques are also improved because it avoids all wastes of competition. In a capitalist economy, large quantity of financial resources are wasted in competitive advertisement. Different entrepreneurs compete against one another to attract consumers or purchasers of goods. Besides, resources are wasted in the production of unnecessarily large variety of goods. Since, under socialism, the State controls production, there is no need to waste resources on competitive advertisement. However, under socialism, some expenditure is incurred on information and educative programme which is not wasteful. Also, under socialism, concentrating production in big firms results in improvement of production techniques. Moreover, there is no idle capacity kept under socialism as is usually the case under capitalism. A socialist State, makes the fullest use of productive activity.

(v) **Social Security and Welfare.** Socialism provides social security for all citizens. The socialists believe that people should be given protection against uncertainties relating to income, work and living conditions and the burden of this provision should be borne by the entire society. That is why modern socialists include in their programme schemes of social insurance covering unemployment, accidents, sickness, old-age pensions, death grants, *etc.* In fact, an individual is provided security from cradle to the grave. Most of the things which are considered essential for individual's health and training are provided by the socialist State either free or at cost of production. A socialist State can provide free of cost milk for children, nursing, education and medical aid. A socialist State is truly welfare State.

(vi) **Economic Stability.** There is another advantage of socialism, *viz.,* it ensures economic stability. Socialism eliminates trade cycles which cause a great hardship to the people. We do not come across depression, unemployment and idle productive capacity in socialist economies. In the capitalist countries, absence of effective demand causes cyclical unemployment and business depression. This absence of monetary effective demand is due to the excess of people's savings over investment expenditure. But since under socialism, the means of production are owned and controlled by the State the level of investment and the level of aggregate demand can also be effectively determined. This ensures economic stability. Sometimes in socialist economies too there can be an imbalance between aggregate demand and aggregate supply but it can be effectively tackled. A socialist State can prevent the imbalance between aggregate demand and aggregate supply from creating trade cycles in the economy and thus makes for economic stability.

DEMERITS OF SOCIALISM

The critics of socialism claim to have picked numerous holes in the socialist fabric. Apart from some silly objections, which have been exploded since long—*e.g.*, socialism would ban religion, abo-

lish marriage and family life, and the dangling of Malthusian bogey to frighten the simple and ignorant minds—earnest efforts have been made to understand socialism and point out some real dangers and difficulties.

(i) **Bureaucracy and Red Tapism.** The most important set of arguments advanced against socialism is one against the **bureaucratic running of the economic machinery.** Bureaucracy is considered to be inefficient in running a business. The civil servant does not feel the same keen self-interest as the employee of a private corporation, where his tenure is not so secure. The civil servant knows that he will get promotion by seniority; no amount of alertness or extra work is going to push him up in the graded list. His main concern is to let things go on somehow without a positive breakdown. One thing that he wants to avoid is public criticism. He will, therefore, take no bold risks and will be content with a moderate measure of success, being merely guided by rule and precedent. Initiative and resourcefulness are at a discount. The business policy will be timid and unenterprising. There is **routine and red-tape,** a place safe for men of mediocre calibre and no room for extraordinary and dashing spirits. No first-rate work can be done by second-rate men. Bureaucracy will further mean bossism, loss of individual liberty, gestapo, *etc.*

(ii) **Not Successful in Business.** A government department cannot claim to score success in business, where quick decisions have to be taken and bold policies are called for. The government personnel is not such as can conquer new fields. The government can, and does, attract able men but conditions in government service are not congenial for the display of extraordinary ability. The reward is not considered worth the trouble.

(iii) **Insufficient Resources.** It is also urged that **government cannot raise the huge amounts of capital** which are necessary for the efficient running and expanding of all industries and trades.

(iv) **Misallocation of Resources.** Under socialism, there will be no automatic indicator for the most economical allocation of the resources of the community among different industries. Under capitalism, there are consumers' preferences which, through price-mechanism, bring about an optimum allocation of these resources. But, under socialism, it will be all groping in the dark. Some commodities will be produced in excess and wasted, whereas there may be a shortage of others resulting in unsatisfied demand. **A chronic mal-adjustment in demand and supply** is feared. The task of organising production, of allocating every acre of land to its proper use, of setting every worker on the right job and of investing every rupee in the direction of maximum benefit is too big to be performed by any single authority.

(v) **Loss of Consumer's Sovereignty.** Under capitalism, the consumer enjoys sovereignty. Of course, this sovereignty is limited by his income, existence of monopoly, *etc.*, yet the domain is wide enough for him to pick and choose. But, under socialism, he will lose this sovereignty altogether. Consumption will have to adjust itself to production. This loss to the consumer is a real loss. He will not be able to maximise his satisfaction.

The State will no doubt fix the prices, but it will be all arbitrary. The price fixation will be rigid and will lack the resiliency of market mechanism, which is sensitive to even the slightest change in the consumers' preferences.

(vi) **Lack of Incentives.** It is also feared that incentive to hard work and stimulus to self-improvement will disappear altogether when personal gain or self-interest is eliminated. People will not give their best. Inventive ability, enterprising spirit and the go-ahead attitude will languish, and creative work will become impossible. It is remarked that "a government could print a good edition of Shakespeare's works, but it could not get them written." [8]

(vii) **Loss of Economic Freedom.** There will be loss of economic freedom under socialism. A serious charge against socialism is that, when freedom of enterprise disappears, even the free choice of occupation will go. Workers will be assigned certain jobs and they cannot change them without the consent of the planning authority. Every worker is dovetailed in the scheme, and he must remain there. This loss of freedom may be really galling.

(viii) **No Economic Equality.** Some people have been disappointed in socialism, because in Russia, where it has been in operation, it has **failed to bring about economic equality.** The difference between the rich and the poor is still there. The dream of a classless society is far from being realised. The workers under capitalism, *e.g.*, in the U.S.A. and the U.K., are not so worse off. They enjoy a high standard of living. They are not convinced that under capitalism the poor go on becoming poorer. The rich are no doubt getting richer but the lot of the poor is also undoubtedly improving. It is thus that some degree of scepticism in the efficacy of socialism as a panacea for all social ills has grown and damped the ardour of some enthusiastic socialists.

(ix) **Concentration of Power in the State.** The greatest danger of socialism is that too much power is concentrated in the State. Under socialism, the State is not merely a political authority but it also exercises unlimited authority in the economic sphere. To the extent all power is concentrated in the State; the danger is that the State is everything and individual nothing. He may not count at all. He

8. Pigou—*Capitalism and Socialism*, p. 80.

is reduced to a cypher. After all, the human institutions are for man and not man for these institutions.

(x) **Loss of Personal Liberty.** That under socialism there is no unemployment is conceded, but the critics retort by saying that there is also no unemployment in a jail. They regard a socialist State as **one big prisonhouse** and they do not think that employment is any compensation for the loss of liberty.

(xi) **Not Scientific.** It may also be pointed out in the end that Marxian **socialism is not so scientific after all.** Labour is not the only source of value and has not the sole right to its appropriation. Few are convinced of the accuracy of Marx's materialistic interpretation of history. Economic motives are no doubt the strongest but they are not the only ones to sway human actions.

Criticism Answered

This looks a formidable array of arguments against socialism, but it is not so formidable as it may seem. The strength of socialism lies in the proved evils of capitalism. The world is periodically plunged into depression causing much dislocation, unemployment and suffering. Capitalism has not been able to ensure stable economic conditions. National resources have been exploitesd for personal profit. Human beings, especially women and children, have been used as so many machines simply to enrich the capitalists. Who can help hearing the "Cry of the Children"?

How long, O cruel nation,
Will you stand, to move the world, on a child's heart,—
Stifle down with a mailed heel its palpitation.
And tread onward to your throne amid the mart;
Our blood splashes upward, O gold heaper,
And your purpole shows your path!

(Elizabeth Barret Browning)

The social conscience feels outraged at the sight of a poor family **working the hardest,** yet not getting two square meals a day, dressed in rags, living in dirty cells, and children dying because they cannot get medical aid or milk. On the other hand, the rich are rolling in luxuries, their horses and dogs are better fed and housed than their fellow-human beings. They perhaps think that the poor man is not after all a human being; he is some other specie! A system which produces such iniquities and callousness stands self-condemned.

Look at the alternative. **Socialism bans trade depression and removes unemployment** which, under capitalism, always hangs over the worker's head like a Damocles' sword. A great worry is off. Free choice of occupation under capitalism is a farce. Who can really choose his occupation? The choice is limited by his parents' means and influence. Sometimes a man would like to get any work that he can. But there is no work. Capitalism throws him on the scrapheap. Who would not like to be put on to a job compulsorily rather than face enforced unemployment and starvation? A socialist State provides permanent and pensionable job for eveybody according to his aptitude and capacity.

A socialist State can allocate the resources of the community among the various uses with the sole consideration of **social security and welfare.** Consumers' wishes have to be replaced by higher social valuations. It is possible that at one stage there may be a shortage of some type of consumers' goods, but this is deliberately done in the higher interests of the society. Surely, there is no harm in making a temporary sacrifice so that we or our children may be able to enjoy better standards later. Only a socialist State can build up a solid foundation for the country's strength and prosperity. The policy of a capitalist economy is a short-sighted one guided by the immediate gains of the entrepreneur.

Under socialism, vast funds can be devoted to the expansion of education of all types, for provision of adequate medical facilities and for rationalisation of industry and reorganisation of agriculture. The result is that **human and material resources of the nation are immensely improved and fully utilised.** A socialist State can easily find resources to help the poor, because the profits of industry, which, under capitalism, go to enrich the already rich and surfeited, are pooled in the State treasury.

Many things, the consumption of which is considered essential for health and efficiency, may be **supplied free or below cost.** No doubt, consumption is regimented and it is curtailed in certain directions, yet there need be no hardhip, for it may be expanded in some other and more desirable directions. A socialist State can provide free milk for children, free nursing, free education and free medical aid. It can give free cinema shows to the workers and provide for them swimming pools, recreational clubs, railway passes to week-end resorts, and light refreshment in the factory gratis. Such things are impossible in a capitalist economy, where lure of the lucre rules. A capitalist only looks to his dividend.

Production of all types can be immediately increased by a socialist State. The achievements of the Russian Five-Year Plans are a standing monument to what can be achieved under socialism by people who not long ago were illiterate, ignorant, backward, conservative and poor peasants. Russia, too, like India, was a country of small farmers, almost all illiterate. Now there is nearly cent per cent literacy; and in production Russia has beaten every other European country which started in the race of industrialisation nearly one century ago. This shows that it is only in a socialist State that planning

can really be effective. This is all due to the fact that all phases of economic life are under the central State direction.

Dangers of bureaucratic management, have been exaggerated. There is a lot of red-tapism in company management even under capitalism. A socialist State can also regulate credit and banking operations, so that financial maladjustments are eliminated.

As for incentive to hard work, a socialist State can, by persistent propaganda and through instruction in the educational institutions, change the very psychology of the people and create **new scales of values.** It can offer production bonuses so that every worker does his best.

Who will do the dirty work? The socialists' answer is that most of it will be done by machinery. Machinery is not being put to such tasks at present simply because man is cheaper than machinery. Thousands of semi-starving people are available under capitalism to do such jobs on a small wages, because capitalism has impoverished the masses. But a socialist State, not working for profit, will be in a position to relieve man from all dangerous, dirty and degrading jobs.

Socialism may not be able to make everybody economically equal. This is due not to lack of organising ability in a socialist State. The cause lies in the innate inequalities among human beings. Nature does not make everyone alike. Everyone is endowed with varying degrees of intelligence and working capacity. No State can help it. It is not a matter for legislation. But a socialist State can discover the aptitude and ability of each citizen and develop them further by training and education so that every citizen is enabled to make his best contribution to the welfare of the State. Real worth will not be allowed to be suppressed or depressed by poverty. **The socialist State can pick up genius even from the lowliest of families and provide it with the fullest facilities and opportunities.** If, therefore, the attainment of economic equality is not considered feasible, at least equality of opportunity can be assured to each, and this will be no mean achievement. There can also be a considerable levelling up of the masses.

The balance seems to be heavily tilted in favour of socialism.

Some Problems of Socialism

It will be of interest to know how Soviet Russia has tackled the various economic problems:

Private property. Private property in the form of a house, a car, a few animals and other consumers' goods is allowed. A man is free to buy government bonds or securities. He can keep a deposit in the bank. Property up to the amount of 50,000 roubles can be transmitted by inheritance. But living on unearned income is discouraged and all unearned income is subject to very heavy taxation. Only bourgeois property which is the result of exploitation, is sought to be abolished.

Pricing System. Under the free-enterprise, competitive and individualistic system, the pricing system automatically solves the major economic problems. Some economists, however, notably Mrs. Hayek and Robbins, are of the opinion that rational accounting is impossible under a socialist regime and that it is all groping in the dark. But there are other economists like Pigou who do not see any difficulty in this. Dickinson and some other economists are of the opinion that the capitalist apparatus of marketing and pricing can be retained in socialism.

Russians have been able to fix prices of the goods. Costs of raw materials and wages, transport and all other costs are added and then a small percentage for a little profit. This gives a selling price. It is a little arbitrary. The prices do not reflect the intensities of consumers' demands, although some note is taken of the relative scarcities. But, in a socialist society, prices of goods will be low enough to clear the available supplies and also high enough to cover the socially necessary marginal costs of production. The price under socialist planning need not be market price as under capitalism. It is purely a book-keeping or accounting price set by the planning authority.

In recent years, however, the crude quantitative goods in the physical units are being replaced by profitability criteria of performance. By this process of economic valuation socialism seems to be moving in the direction of capitalism.

Supply of Labour and Wages. There is now freedom of choice of occupation. There are also ample facilities for technical training. The Government is prepared to bear the cost of training on the condition that the trainees, after completing training, work in government factories for a term of years on conditions settled beforehand. Money wages are paid and there are variations according to ability, efficiency and the nature of work.

Standard wages are fixed after a thorough motion-study and time-study in order to ascertain the standard time required for a job. Efficiency premia are paid to better workers who take less time. Wages are also supplemented by the payment to the workers of a lump-sum social dividend payment. This payment varies with the size composition and health status of the family. By means of such payments, inequalities of income are mitigated. If there is a comparative shortage of some type of labour, higher wages are of course offered to attract the right type and sufficient supply of labour.

Workers are assigned definite jobs. The workers could also be transferred from one place to another

just like government servants. The government tries to adjust supply to demand.

Finance. The Russians had repudiated foreign debts and could not hope to secure foreign loans. They relied, therefore, mostly on created money. Paper money was issued by the State in enormous amounts. There was inflation with all the usual consequences—exorbitant prices and a very high cost of living, *etc.* They also raised loans from the people. Later on, income from socialised industry flowed in and helped to finance the later stages of planning.

Rent. Even a socialist State cannot do away with the concept of rent. Change of economic order from capitalism to socialism will not turn scarce land into an unlimited quantity. Rent as an index of productivity will help in the best allocation of the available land among its various types of land, the good land being put a higher tag.

As Samuelson puts it, "Only by putting a price upon inert sweatless land are we using it, and sweating breathing labour, most productively! The price or rent of land rises so as to ration its limited supply among the best uses."[9] Even a socialist State will have to direct land from one use to another so as to make its marginal productivity in all uses the same. This marginal productivity will be indicated by rent. This is the only way to ensure a correct allocation of valuable human or material resources.

Interest. The Russians have not abolished interest altogether. The Government itself pays interest on State loans. Interest shows an attempt to bring the demand for, and supply of, capital into equilibrium. The banks also pay interest on personal accounts. Interest as remuneration to the capitalist, *i.e.,* payment to private owners of idle money, does not occupy an important place in Russian economy, since private capital has practically disappeared. The State borrows and pays interest and appropriates the profit of industry.

What role does interest play in a socialist State? In a capitalistic State, we know that interest performs three important functions (a) It determines people's income from bonds and other assets; (b) it is a necessary payment to induce people to part with liquidity; and (c) it relates future and present economic values, *i.e.,* it helps society to decide how much of the national income should be invested in capital formation and where should the capital be used.

Now the first two functions have no bearing in a socialist State. Since capital is no longer the property of private individuals, interest as an income-determining factor or as an inducement for dishoarding does not exist. But whatever the form of economy, interest must continue to perform the third function, *viz.,* to determine the allocation of the economic resources of the community as between present and future and the allocation of capital among different uses in the present.

The rate of interest acts like a sieve or a rationing device. Capital is scarce and the uses for which it is wanted are unlimited. The rate of interest is the indicator of the directions in which capital should move. Obviously, enterprises with a prospective yield at 12 per cent are to be undertaken in preference to those yielding 10 per cent. "The rate of interest must be used to allocate scarce capital supplies optimally and to determine the order of priority of alternative projects."

Wages. The system of setting accounting prices on labour, as in the case of other productive resources will not do, for the amount of labour is not a fixed quantity. People can choose their occupation and they can also choose whether to work more or work less, *i.e.,* whether to prefer income or leisure. Hence, it is essential to have a system of **actual market wages rather than accounting wages.** These rates will vary according to the agreeableness or disagreeableness of the job, possibility of supplementary earning, training or skill required to do a job, productivity of individual workers, *etc.* Marginal productivity will determine the wage.

Thus, there will be no dead level of wages in a socialist State. The wages will depend on the valuation that society places on the needs and worth of individual workers and the necessity for compensation to those who have to do dirty, irksome and arduous jobs. Inequality of incomes will no longer be accounted for by inequalities of property but by such factors as mentioned above.

Allocation of factors of production. The State planning authority tries to estimate the amounts of factors required for the targeted production in an industry and arranges for the supply. It is first decided which industries have to be developed and to what extent. The factors of production are diverted in channels set by the State and according to consumers' preferences. For example, the Russians concentrated first on heavy industries. Naturally, there was a shortage of consumers' goods whose prices shot up. In a capitalistic system, factors of production would rush towards consumers' goods industries to make up for the deficiency. But a socialist State does not allow this diversion. Shortage would continue and rationing and price control introduced. In Russia, the normal functioning of the price-mechanism, which brings about an optimum distribution of resources, as judged by the consumers' valuations, is nullified by State action.

Thus, the resources are allocated, not according to the valuation of the consumers but, according to the valuation of the State. The State decides what is best for the nation at a particular period of its life and arranges the distribution of resources accordingly. The consumers must adjust their demands according to production and the exigencies of the State.

9. *Economics,* 1948, p. 598.

69 MIXED ECONOMY

Meaning

We have discussed in the preceding chapters the two economic systems, *viz.*, capitalism and socialism. But there is also a third one, *viz.*, the mixed economy. It is neither pure capitalism nor pure socialism but a mixture of the two. In this system we find the characteristics both of capitalism and socialism. As Samuelson observes, "Within the advanced countries themselves, the scene was drastically changed from the Victorian days of laissez-faire capitalism. Almost unconsciously, undiluted capitalism had been evolving into a mixed economy with both private and public initiative and control. The clock of history sometimes evolves so slowly that its moving hands are never seen to move."[1]

In the modern world, what we find mostly are mixed economies. Mixed economy means that it is operated both by private enterprise and public enterprise. That is, private enterprise is not permitted to function freely and uncontrolled through price-mechanism. On the other hand, the government intervenes to control and regulate private enterprise in several ways. It has been realised that a free functioning of private enterprise results in several types of evils. For instance, free functioning of private enterprise produces trade cycles, *i.e.*, sometimes depression and unemployment and at other times booms and inflationary situation. Besides, free functioning of private enterprise results in extreme inequalities of income and wealth. Under the laissez-faire policy pursued by the State in the free enterprise economy, the weaker and vulnerable sections of society as well as the indigenous industries do not get protection.

It is also realised that in the under-developed countries, like India, economic development cannot be achieved at the desired rate of growth without any active government help and guidance. Hence the government in such countries actively participates in economic activities in order to minimise the evils of unadulterated capitalism and to accelerate economic gowth. That is why most of the capitalistic economies of the world have become mixed economies, because in all economies the economic functions of the State have increased.

The laissez-faire policy propounded by Adam Smith and other classical economists has been almost altogether abandoned and the economies even of the U.S.A. and the U.K. have become mixed economies. Eminent American economists like Prof. Samuelson and Hansen call the American, English and the French economies as "Mixed Capitalist System" or "Mixed Enterprise System" because their governments interfere in the working of the economy by controlling and regulating it and they actively participate in economic activities.

Two Types. In one type, the means of production are owned by private entrepreneurs. But the government directly controls and regulates the working of the economy through its monetary and fiscal policies. For example, it institutes price control, licensing system, import control, exchange control, control over capital issues, *etc.* The government does not take over the ownership of the means of production to undertake production itself. Even if it undertakes production directly, it is comparatively very little as compared with the volume of production under the control of private entrepreneurs. That is why such a mixed economy is called **'mixed capitalist system'.** It is predominantly capitalistic and the government only influences its working and growth through appropriate fiscal and monetary policies. It controls and regulates private enterprise so that the evils of free private enterprise and of the price system are avoided and some pre-determined objectives are achieved.

In such mixed enterprise systems the government confines its productive activity only to the produc-

1. Samuelson, P.A., *Economics*, Ninth Edition, p. 867.

tion of defence equipment and provision of public utility services like water, gas and electricity and transport facilities. Such a mixed economy is also called 'mixed capitalism' or 'controlled capitalism."

Another type of mixed economy is one in which the government does not merely control and regulate the private enterprise system by means of direct controls and appropriate fiscal and monetary policies but it also plays vital role in the actual production of commodities. In such a mixed economy, several basic and strategic industries are owned by the State and their operation and management is in the hands of the government. The remaining industries are owned by private entrepreneurs and they operate and manage them. But the government controls and regulates the private sector through direct controls and appropriate monetary and fiscal policies.

The main difference between the mixed economy of this type and of the former type is that in this type of mixed economy, the government controls the means of production in a much larger measure and itself undertakes production. Whereas, the first type of mixed economy is biased more towards capitalism, the latter type is biased more towards socialism, the Indian economy is an example of this second type of mixed economy.

In the Indian economy, both the public sector and private sector are in operation. The foundations of mixed economy in India were laid by the Industrial Policy Resolution of 1948 which was modified by the Industrial Policy Resolution of 1956. According to these resolutions, the various industries were divided between the two sectors, *viz.*, the private sector and the public sector. The responsibility for the developlment of several basic, heavy and strategic industries was assigned to the State and the development of the rest of the industries was left to the private sector. Even the private sector is controlled and influenced by the Government of India by means of direct controls or through appropriate fiscal and monetary policies.

It is clear from the above that the mixed economy is a mixture of capitalism and socialism. The mixed economy tries to avoid the two extremes of pure capitalism and pure socialism and the evils associated with each. In other words, it strikes a middle path between capitalism and socialism. We have mentioned above that in pure capitalism only private sector establishes and runs industries and the government does not interfere in any manner. As against this, under pure socialism all the means of production, *i.e.*, industries, agriculture, land, mines, *etc.*, are owned and controlled by the State and the State operates them. In the mixed economy, on the other hand, both private and public sectors operate. Some industries are owned and managed by the State and other industries are owned and managed by the private sector. It is thus clear that, in a mixed economy, all industries are not nationalised. Only those industries are nationalised and put under the operation of the public sector which are very essential for the speedy economic development of the country but in which the private entrepreneurs are reluctant to invest because either the return is insufficient or long delayed. In a mixed economy, the sphere of the two sectors, *i.e.*, the private sector and the public sector, are clearly demarcated, and they combine and co-operate in the work of economic development of the country.

As we have said already, the economies of the U.S.A. and the U.K. have also today become mixed economies. But the Indian mixed economy is different from them, because in the Indian economy, the public sector has been assigned a much more extensive, more active, and more strategic role to play.

Main Features of Mixed Economy

Having understood the meaning of mixed economy, we are now in a position to bring out the main features or characteristics of such an economy. It will also be clear from these characteristics how a mixed economy functions. The following are the main characteristics of a mixed economy:

(i) **Co-existence of the Public and Private Sectors.** The chief characteristic of a mixed economy is that in this economy both public sector and the private sector function together. They co-exist. The industries of the country are divided into two parts. In one part are the industries the responsibility for the development of which is en[illegible] to the State and they are owned and managed by the State. Other industries are left under the authority and control of the private entrepreneurs. The private sector is free to develop them and start new enterprises in this sector. Generally, the basic and heavy industries, the industries concerned with the production of defence equipment, atomic energy, heavy engineering industries, *etc.*, are put in the public sector. On the other hand, the consumer goods industries, small and cottage industries, agriculture, *etc.*, are generally assigned to the private sector. It may be borne in mind that the government does not work against the private sector. On the contrary, the government helps and encourages the private sector by providing them several incentives and facilities so that the industries in the private sector are able to develop properly and make the country's economy efficient and strong.

(ii) **Role of Price System and Government Directives.** Another characteristic of mixed economy is that it is operated both by the price system and the government directives. So far as the public sector is concerned economic decisions relating to production, prices and investment are made by the government or authorities appointed by the government. But the private sector in the mixed economy is operated by price-mechanism. In other words, in

the industries in the private sector, the decisions regarding investment, production, prices, *etc.*, are made by private entrepreneurs—capitalists and industrialists—with the object of making maximum profits on the basis of the price system. It is clear that in the mixed economy the allocation of productive resources is partly determined by the price system and partly by the government directives.

(iii) **Government Regulation and Control of Private Sector.** In a mixed economy, the government adopts necessary measures to regulate and influence the private sector, so that it may function in the interest of the nation rather than exclusively in the interest of the private entrepreneurs. For this purpose, it introduces the licensing system according to which government approval or licence is essential for setting up a factory. If the government considers that in a certain industry already there is excessive investment or excess capacity, no new licences are issued for setting up factories in that industry. Licensing system is the instrument by which the government controls and regulates industrial investment and output. The government also controls and regulates the private sector through appropriate monetary and fiscal policies. For this purpose, the government gives rebates ar tax concessions and credit facilities at low and reasonable rates so that the private entrepreneurs are induced to invest in those industrial lines.

(iv) **Consumers' Sovereignty Protected.** In mixed economy, the sovereignty of the consumers is protected. Like socialism, the mixed economy does not put an end to consumer's sovereignty. The consumers are free to buy commodities of their choice and the private entrepreneurs produce commodities according to consumers' demands or preferences, although the government can control their prices in public interest so that they can be prevented from rising unduly high. In fact, the aim of price control is to protect the consumers from exploitation by private producers and capitalists. Besides, the government can also ration the commodities in short supply so that the limited available quantities can be fairly distributed. It is clear that, in spite of some restrictions imposed by the government, the consumers are free to purchase the goods they like. It is their demand or preferences which guide production in the private sector.

(v) **Government Protection of Labour.** In a mixed economy, government protects the weaker sections of society especially labour. That is, it saves labour from exploitation by the capitalists. In the developed countries, in the beginning of Industrial Revolution, the greed and selfishness of the factory owners inflicted untold hardships on male labour, women and children. Social conscience was roused on seeing the pitiful and miserable working and living conditions of such labour. The government realised its responsibility for protecting labour from exploitation by industrialists and factory owners. Now several factory Acts have been passed to regulate the working conditions of labour. Minimum wages and the working hours have been fixed. Restrictions have been imposed on the employment of small children in factories. Labour is paid compensation for accidents while at work. The government also takes necessary steps to prevent industrial disputes. These things are done even in mixed economies of 'controlled capitalism' type.

(vi) **Reduction of Economic Inequalities.** The governments in mixed economies take necessary steps for the reduction of inequalities of income and wealth. Extreme inequalities of income and wealth are socially unjust, politically undesirable and economically harmful. Extreme inequalities of income reduce social welfare. Income inequality creates inequalities of opportunities for education and training in favour of high-income groups. The extreme inequalities of income create class distinctions and generate class-conflict which splits the whole society into two warring camps—the rich and the poor or the 'haves' and the 'have-nots'. The rich exploit the poor. Modern governments try to reduce economic inequalities for promoting social justice. and social stability and social welfare, increasing production and for providing equal opportunities for all. For this purpose, government levies progressive taxation, wealth tax, death duties, gift tax, *etc.* On the other hand, free education, free medical aid and old-age pensions, for the poor, stipends for poor students are some of the remedies adopted for distributing the extra income of the rich among the poor.

As a result of the above-mentioned measures, which have been adopted by the governments of different countries like the U.S.A., the U.K., Norway and Sweden, inequalities of income and wealth have been somewhat reduced. The Government of India also has decided to introduce a socialistic pattern of society and for that purpose reduce inequalities of income and wealth. This is a major objective of our Five-Year Plans. But so far the Government has not succeeded in achieving this desirable objective. In fact, it is said that in India economic inequalities have increased instead of decreasing in the planning era. The fruits of economic development are concentrating in the hands of a few rich people. Our Government is now fully seized of the problem of growing economic inequalities and it may be hoped that in future strong measures will be adopted for reducing economic inequalities. In this way, it will be fulfilling one of the main purposes of a mixed economy.

(vii) **Control of Monopoly.** In a mixed economy, the government tries to control and regulate monopolies. A charge against monopolies is that they

reduce output and raise prices in order to get maximum profit. The monopolist thus uses his monopoly power to exploit the consumers. He fixes a price which is above the marginal cost of production and in this way reduces consumers' welfare. Such a price-output policy results in misallocation of productive resources of the community. Besides, the excessive profits made by monopolists result in accentuating economic inequalities in the country. Moreover, monopoly creates unemployment by reducing output and thus hampers industrial development.

The government tries to control and regulate monopolies in order to remove the above evils and make them function in public interest. It appoints an ad hoc or permanent commission to fix a fair price of the monopolised products. Only a reasonable return is permitted on investments made by monopolists. In other words, a monopolist can earn only a fixed rate of dividend. Also, when the government considers it necessary in public interest, it takes over monopolies and operates them in public interest. Moreover, some governments have passed legislation to prevent the establishment of business combinations which lead to the creation of monopolies.

Conclusion. We have studied above that in a mixed economy public sector and private sector operate side by side. In the public sector, the development of industries is directly under the government: hence it is possible to make sure of their operation according to plan and with proper organisation. In the private sector, however, there is need for some controls and incentives so that they are also developed according to plan, *e.g.*, price controls, influencing them by means of proper investment, licensing of new industries control over capital issues, control over imports, prevention of concentration of economic power and creation of monopolies, *etc.*

Critical Evaluation of Mixed Economy

Let us assess briefly the working of the mixed economy system. Although, as we have said above, all capitalistic economies have become more or less mixed economies, yet we do not propose to make a survey of the working of the system elsewhere. We confine ourselves to the assessment of the working of mixed economy in India, for, as India is the biggest democracy, it is also the biggest experiment in mixed economy.

We may notice two opposite views on the working of mixed economy: one represented by the business community or 'big business' properly speaking and the other by the political leaders in the Government. These views are usually given expression to in the annual conference of the Chambers of Commerce which are addressed usually by the Prime Minister and other high government spokesmen. There is usually a wordy warfare between the two. The business leaders are frankly critical of the government and the government spokesman of the business community. The government charges the business of the community with blackmarketing, profiteering and not being patriotic enough to play a proper role in the economy, whereas the business leaders hold the government responsible for inflation, economic stagnation and for the ills of the economy and of trying to squeeze out the private sector in a variety of ways.

For instance, in the annual meeting of the Associated Chamber of Commerce and Industry held in April, 1975, J.R.D. Tata said that mixed economy was dead or dying. He said, "our economy will continue to stagnate while our population grows and we shall end up before the turn of the century under dictatorship or in a state of chaos and violence." The Prime Minister, on the other hand, extolled the virtues of the public sector and harped on its achievements. Mr. P. N. Haksar, Deputy Chairman of the Planning Commission, addressing the annual session of the Federation of Indian Chamber of Commerce and Industry termed Mr. Tata's speech as a 'funeral oration' and said that this oration would be justified if mixed economy was really dead. He said that the problems of the country could not be solved by "composing lyrical passages on the death of mixed economy, raising 'macabre' vision of the hold of communists". He further said that it would be doing an injustice to argue that the concept of mixed economy obtained only abroad and what obtained in India was "mixed-up economy."

These charges and counter-charges only blur the true vision of mixed economy. The reality is that despite the present ills of the Indian economy, the marriage of the public and private sectors in Indian economy is merrily going on and doing well. Both sectors are making a valuable contribution to the successful functioning of the Indian economy. As pointed out by Mr. Haksar, the country produced in terms of output 90% of the goods and services through private economy. This bears ample testimony to the vitality and virility of the private sector. Far from being dead, it is alive and kicking. There is little danger of its becoming extinct or being swallowed up by the public sector. While private sector was a part of the national economy, State control is essential in the interest of integrated growth of the economy. Mixed-economy in India is a byproduct of the government involvement in the task of economic development of the country. There is no doubt that government has played a remarkable role in developing infrastructural facilities and setting up big industrial units which have helped the private sector a great deal in its functioning.

The fact is that the public sector and the private sector are the two necessary limbs of the economy and both must be in good health and functioning properly. There should be cordial co-operation between the two. Mixed economy cannot function in a State of cold war. Besides, government regulation is essential to bring about a proper co-ordination between the two wings of the economy. It may also be borne in mind that mixed economy cannot function in a static framework. It is a dynamic concept and the proper relationship between the two sectors must go through a continuous evolutionary process to ensure that they do not work at cross purposes. Both sectors must work in the interest of the economy as a whole rather than promote their own selfish interests. "That mixed economy which reflects the callous indifference of the omnipotent bureaucratic machine of the public sector on the one hand and massive profiteering with unutilised capacities and high prices of the private sector on the other, stands totally condemned in the eyes of the people. ... The amorphous opportunism of the political elite and the greed of the private big business stare us in the face every day."[2] This situation must change so that the economy is restored to full health and soundness.

MIXED ECONOMY IN THE CONTEXT OF INDIAN ECONOMY

In India, the commencement of the planning era saw the beginnings of mixed economy. The First Five Year Plan laid down that the State must not only assume the responsibility for providing the infrastructural facilities, but also enter directly in the industrial field. It was recognised that the State must undertake to develop basic and strategic industries. It was realised that both public and private sectors must join in the common task of accelerating economic growth. The concept of mixed economy envisaged the operation of both private and public sectors. Barring certain key industries and industries of strategic importance, over a large part of economic activities, including not only the organised industry but also agriculture, small industry, trade and commerce, individual effort and private initiative were considered necessary and desirable.

The Industrial Policy Resolutions passed in 1948 and 1956 gave a concrete shape to the concept of mixed economy. According to the Industrial Policy Resolution of 1948, industries in India were broadly divided into four categories: (i) Exclusive government monopoly; (ii) Government-controlled sphere; (iii) Industries subject to State regulation and control; and (iv) the rest of the industrial field which was to be the sphere of private enterprise under general control of the State. In other words, the whole industrial field was split up into two broad sectors viz., public sector which was exclusively reserved for the government and the private sector in which private enterprise could operate freely. The Industrial (Development and Regulation) Act, 1951 was the main instrument by which the Government controlled and regulated private industrial enterprise i.e. controlled the location, setting up and expansion of private industrial undertakings.

In 1954, the Parliament accepted Socialistic Pattern of Society as the objective of social and economic policy. In order to realise this objective it was considered essential to accelerate the rate of economic growth, to speed up industrialisation and to expand the public sector. It was also necessary to reduce disparities in income and wealth and to prevent private monoplies and concentration of economic power in the hands of a small number of individuals. Hence the State had to assume progressively a predominent and direct responsibility for setting up new industrial undertakings. All this necessitated a fresh statement of industrial policy which was announced in 1956.

The main features of the 1956—industrial policy were:—

(i) A new classification of industries putting a larger number of them in the public sector and thus putting direct responsibility on the government for the future development of industries over a wider area.

There was to be another category of industries which were to be progressively state-owned in which therefore generally the State would take the initiative in establishing new under-takings but in which private enterprise would supplement the effort of the State. In the remainder of the industrial sector, the initiative and enterprise for development would be with the private sector. The state would simply encourage and facilitate the setting up new industries.

Although a demand for the revision of industrial policy was made from time to time, but the 1956 resolution has continued to govern the industrial policy of the government. Thus the frame-work of mixed economy has continued to be strengthened. The Janata Governments' policy emphasised the prevention of concentration of economic power (which means the strengthening of the public sector) and investment policy designed to improve the efficiency of the public sector.

The working of the mixed economy in India during the last few years has established the basic soundness of the concept of mixed economy. The structural transformation that has taken place in the field of Indian industry would not have taken place unless both private and public sectors contributed.

2. Dr. J.D. Sethi, "Tragic Myth of Mixed Economy," *The Tribune*, April 17, 1975, p. 4.

BOOK SEVEN :

ECONOMICS OF DEVELOPMENT AND PLANNING

Part I
Economics of Development

70 ECONOMIC UNDER-DEVELOPMENT

We now pass from statics or comparative statics to dynamic analysis. In static analysis, for example, we discuss how equilibrium price is determined when the demand and supply curves are known and remain unchanged. Static analysis helps us to analyse a situation where consumers, producing firms, industries, *etc.,* are in stable or static equilibrium at certain levels of prices, output, income and employment. In comparative statics, we analyse a situation, which has come about after a once-for-all change. In other words, we compare the two stable equilibria—one before and the other after the change. For example, suppose demand has permanently gone up. Now there will be new equilibrium price or an equilibrium different from the first.

But these methods of analysis have their limitations and cannot analyse many important and pressing problems, for example, the problems of economic fluctuations—booms and slumps and the problems of economic growth. In the study of economic growth, instead of looking at the rates of output per period of time, we look at the rates of change in the rate of output between periods of time. In static analysis, certain basic elements in the economy (*e.g.,* size and composition of the population, natural resources, consumers' tastes, production techniques, *etc.*) are taken as given and fixed. These basic factors determine the levels of income, output and employment. In analysis of economic growth, some or all these basic elements are supposed to change and we have to determine the rates at which output is changing. We study the conditions of steady growth rate or determinants of economic growth.

Let us first study how the theory of economic growth has emerged and has come to occupy the attention of economists today.

Emergence of Theory of Growth

In the course of the last twenty five years or so, a separate branch of economic theory has emerged which studies the factors which contribute to increase the level of national income and output of a country and raise the standard of living of its people. This new branch of economic theory is variously levelled as **'Economics of Growth,' 'Economics of Under-development,'** or **'Economics of Development.'** For our purpose here, we shall use the term "Economics of Development."

The factors determining economic growth were discussed by Adam Smith, the father of political economy, and other classical economists. But, after the classical economists, owing to ascendency of marginalism, the economists mainly concentrated on the study of allocation of resources and determination of relative prices. In the beginning of the present century, and especially in the early 1930's, when the Great Depression engulfed the capitalist countries, the economists were largely engaged in finding out suitable explanation of depression and trade cycles. In 1936, Keynes's **General Theory of Employment, Interest and Money,** various aspects of which have already been discussed, brought about a revolution in economic thinking. Keynes explained clearly the true nature of depression and economic fluctuations.

But Keynesian theory only deals with the determination of income and employment in the short run, on the contrary, economic development is a long-run process. It is, therefore, widely recognised that the Keynesian theory of income and employment has serious limitations when applied to underdeveloped countries. The problem which Keynes was out to solve in the nineteen thirties was one of economic instability and of low national output brough about not by the dearth of capital but in spite of the availability of capital. In underdeveloped countries, the main problem has been one of insufficiency of capital. In these countries, the problem essentially is one of narrowness of the

margin over and above the consumption demand based on the extremely low standards of living.

Since the end of World War II, the economists started taking lot of interest in economic development. The reason was that the capitalist countries like the U.S.A., the U.K. and European countries were keen on stabilising the conditions of full employment. In this connection, economists like Sir Roy Harrod in England and Evsey D. Domar in the U.S.A., put forward models of steady economic growth. According to them, in order to maintain full employment, it is necessary to have steady and continuous growth and increase in net investment. Besides, the governments in under-developed countries—in Asia, Africa, Latin America, and East European countries—have increasingly become development-minded. A good many of these countries have embarked on development planning to cross the hurdle of stationary equilibrium of under-development. Their aim is to catch up with the advanced and highly developed nations of the world in the shortest possible time.

Poverty, hunger, disease, illiteracy, and lack of opportunity for self-development have been the lot of a large majority of people in under-developed countries. Poverty there is old but the awareness of poverty and the hope that something can be done about it are new. In fact, a **"revolution of rising expectations"** is currently sweeping the under-developed countries. In these countries, many theories were propounded about initiating and accelerating the process of economic growth.

Definition of an Under-Developed Economy

It is not easy to define an under-developed economy. According to the United Nations experts, an under-developed country is one "in which per capita real income is low when compared with the per capita real incomes of the U.S.A., Canada, Australia and Western Europe." [1] This definition, though it focusses attention on a very important characteristic of under-development, *viz.*, poverty, can by no means be considered adequate. A country may be poor and yet not under-developed in relation to its resources, if the resources happen to be scanty or inadequate. It may have fully developed its resources and yet be among the poorest countries in the world.

According to Prof. Ragnar Nurkse, 'under-developed' countries are those which "compared with the advanced countries, **are under-equîpped with capital in relation to their population and natural resources."** [2] But this too is not a wholly satisfactory definition. As Nurkse himself points out, "Economic development has much to do with human endowments, social attitudes, political conditions and historical accidents. Capital is necessary but not a sufficient condition of progress." [3]

The Indian Planning Commission defines an under-developed country as one "which is characterised by the co-existence, in greater or less degree, of unutilized or under-utilized manpower, on the one hand, and of unexploited natural resources on the other." The existence of idle resources, as stressed by this definition, is undoubtedly an important characteristic of an under-developed economy. But there is a snag in it: It does not clearly indicate the causes of the existence of idle resources. Resources may be, and are very often, idle even in the highly developed capitalist countries, particularly in times of depression. But such countries cannot be classed as 'under-developed' on that ground. As such, an acceptable definition of an under-developed country must pinpoint the main factors which lead to the existence of idle or under-utilized resources in such an economy. If the resources are idle because they have not been property exploited or developed, it indicates a state of economic under-development.

Hence, an economy will be considered under-developed:

(a) if its per capita income is low.

(b) if the natural resources and manpower in the country remain unutilised or under-utilised on account of lack of economic development; and

(c) if it is possible to raise its level of national income and per capita income by properly utilising its natural resources and manpower.

Prof. Viner observes: **"A more useful definition of an under-developed country is that it is a country with good potential prospects for using more capital or more labour or more available natural resources, or all of these to support its present population on a higher level of living."** [4]

To Colin Clark, one of the pioneers in the studies of under-developed economies, economic development consists in the progressive enlargement of the proportion of tertiary occupations in the economy. But under-developed economies are those in which primary occupations predominate. While it is broadly true that, with rising standards of living there occurs a proliferation of the various kinds of personal services (*i.e.*, tertiary occupations), it has been often observed that in 'under-developed' countries the proportion of domestic servants is usually quite large. And since domestic service also

1. U.N.O. *Measures for Economic Development of Under-developed Countries*, 1951, p. 3.
2. Nurkse, Ragnar: *Problems of Capital Formation in Under-developed Countries*, p. 1.
3. *Ibid.*, p. 2.
4. Viner, J.—"The Economics of Development" in *T Economics of Under-development*, edited by A.N. Agarw and S.P. Singh, p. 12.

falls in the category of tertiary occupations, this test of tertiary occupations cannot, therefore, be regarded as an unmistakable one.

From the above discussion, it is obvious that defining an under-developed country is by no means a simple task. In current discussion, all low-income countries are generally classified as under-developed. In general, all those countries with per capita income less than 25 per cent of the United States level or roughly less than $500 per year are included among under-developed countries. There is also a broad agreement among economists that low-income levels are largely associated with deficiency of capital.

CHARACTERISTICS OF UNDER-DEVELOPED ECONOMIES

The general nature of an under-developed economy may be gathered from the common economic characteristics of such an economy. It may be too much to talk of common economic characteristics of under-developed countries in view of the wide diversity among under-developed countries, as revealed by the numerous case-studies that have been made. While it would be very difficult to locate a **representative** under-developed country, it is much easier to bring out some fundamental characteristics common to under-developed countries, which are considered below:

(i) **Deficiency of Capital.** The insufficient amount of physical capital in existence is so characteristic a feature in all under-developed economies that they are often called simply **'capital-poor'** economies. One indication of the capital deficiency is the low amount of capital per head of population. Shortage of capital is reflected in the very low capital-labour ratio in the low-income countries. According to a survey by the United Nations Department of Economic Affairs in 1949 real capital per worker in Asia and Far East excluding Japan was only 10 per cent of that of the U.S.A.[5]

Not only **is the capital stock extremely small,** but the current **rate of capital formation** is also very low. In most under-developed countries, investment is only 5 per cent to 8 per cent of the national income, whereas in the United States, Canada, and Westesrn Europe, it is generally from 15 per cent to 18 per cent.

The low level of capital formation in an under-developed country is due both to the weakness of the inducement to invest and to the low propensity and capacity to save. In such an economy, the low level of per capita income limits **the size of the market demand for manufactured output,** which weakens the inducement to invest. The low level of investment also arises as a result of the lack of **dynamic entrepreneurship,** which was regarded by Schumpeter as the focal point in the process of economic development.

At the root of capital deficiency is the shortage of savings. The level of per capita income being quite low, most of it is spent in satisfying the bare necessities of life, leaving a very low margin of income for capital accumulation. Even with an increase in the level of individual incomes in an under-developed economy, there does not usually follow a higher rate of accumulation, because of the tendency to emulate the higher levels of consumption prevailing in the advanced countries. Nurkse has called this tendency **"demonstration effect."** It is usually caused through media like films, or through foreign visits.

Generally, there exists a marked inequality in the distribution of incomes in under-developed countries. This should have resulted in a greater volume of savings available for capital formation. But most often the sector in which the greatest concentration of income lies is the one which derives its income primarily from non-entrepreneurial sources, such as unearned rent and interest. The attitudes and social values of this sector are often such that it is prone to use its income for **'conspicuous consumption,'** investment in land and real estate, speculative transactions, inventory accumulation and hoarding of gold and jewellery. If these surpluses were channelled into productive investment, they would tend to increase substantially the level of capital formation.

As the capitalist sector, either private or State, constitutes a very small part of the economy of an under-developed country, industrial profits constitute a much smaller proportion of its national income as compared with that in advanced countries, where they constitute a considerable proportion of the national income. It was the increasing volume of profits arising in the private capitalist sector in England in the 19th century and in recent times in the State capitalist sector in the U.S.S.R. that played an important part in the accumulation of capital in these countries.

(ii) **Excessive Dependence on Agriculture.** Most under-developed countries are predominantly agricultural. A great majority of population, usually between 70 and 80 per cent, are engaged in agriculture and allied occupations, whereas in the developed countries 15 per cent or even less draw their sustenance from agriculture. This excessive dependence on agriculture is due to the fact that non-agricultural occupations have not grown at a rate commensurate with the increase in population owing to lack of sufficient investment outside agriculture. Hence, a growing labour force has had to be absorbed in agriculture. With the accelerated

5. U.N. Development of Economic Affairs—*Economic Survey of Asia and the Far East*, 1949, (1950), p. 296.

growth of population in the last few decades, the pressure of population on the available land has become very great and has produced serious consequences. The labour-land ratio being high, agricultural holdings have become subdivided into small plots, which do not permit the use of modern mechanical methods of production.

Under-developed countries produce relatively large proportion of their national income in the agricultural sector. However, the share of agriculture in the national income is considerably smaller than its share in the total employment in the economy, reflecting low productivity per man in the agricultural sector. For instance, in India, while agriculture accounts for about 50 per cent of the total national income, it employes no less than 70 per cent of the country's total population.

Thus, though under-developed countries are predominantly agricultural, they are nonetheless much less efficient in agriculture than are the industrial countries. As Prof. J.K. Galbraith has put it, "a purely agricultural country is likely to be unprogressive even in its agriculture." Prof. Gunnar Myrdal explains this paradox thus: "Industrialization creates technology which can then be applied to agriculture, but not vice versa." Too much concentration on land and too low a ratio of capital per worker explains the low productivity per worker in the agrarian sector. Harvey Leibenstein observes: "As long as industrial capital remains relatively scarce and as long as the vast majority of the labour force is engaged in agriculture, it would appear to be reasonably safe to postulate that, under these circumstances and at least for the early stages of development, the system is operating under diminishing returns with respect to labour."[6]

(iii) **Inequalities of Income and Wealth.** Another distinguishing characteristic of the under-developed economies is the disparities in income and wealth enjoyed by the rich and poor sections of society. The lower national income of the economically backward countries is more inequitably distributed than in the advanced countries. According to Colin Clark's estimates, labour's share of net income in the rich countries, like the U.S.A., the U.K., Canada, Australia, New Zealand and Switzerland was more than 70 per cent in 1950, while in Chile and Mexico it was below 60 per cent.[7] According to a recent estimate, the share of wages and income of self-employed persons in India is 24 per cent of the total national income.[8] In the under-developed countries, unearned income of land-owners in the form of rent forms a very higher proportion as compared with the developed countries. But owing to a decline in the share of property income, there is tendency for the share of the incomes of the richest group in advanced countries to go down. On the other hand, the share of wages is gone up.

Although, in the under-developed countries, there is concentration of incomes in a few hands, yet in absolute terms such incomes are too small to meet the requirements of the economy. Besides, such incomes are usually diverted to non-economic investments such as jewellery and real estate or they are dissipated in unproductive social expenditure, *e.g.*, on marriages and are, therefore, not available to finance economic development.

(iv) **Dualistic Economy.** The under-developed countries present sharp contrast in all walks of life. There is the old and new, developed and under-developed, the educated and the illiterate, the rich and poor existing side by side. It is both a bullock cart and motor car economy. There are pockets of extra rich and ultra modern people and vast masses steeped in abject poverty. There are efficient modern industries and the languishing indigenous handicrafts, and so on.

(v) **Lack of Entrepreneurial Ability and Skilled Technicians.** In the under-developed countries generally, there are very few people, who can be described as daring and dynamic entrepreneurs. There is also woeful lack of technical know-how.

(vi) **Inadequate Infrastructure.** The under-developed countries are also characterised by the lack of sufficient economic and social overheads. The means of transport and communication, irrigation and power, the banking system, the educational and medical facilities are all imperfectly developed and they are utterly inadequate to serve the existing population.

(vii) **Foreign Trade Orientation.** An under-developed economy is generally foreign trade-oriented. Traditionally under-developed countries have exported raw materials and imported consumer goods and machinery. The ratio of export production to total output is normally high. Indeed, some of the countries like Ceylon, Malaya, Burma and Thailand can be called **export economies** in so far as a significant part of the national output of these countries is exported. In some countries like Chile, Egypt and Cuba, the export of only one or two staple commodities accounts for a major part of their foreign exchange earnings.

This excessive dependence on exports has certainly deterimental consequences for an under-developed economy Firstly, the economy becomes biased towards production for exports to the comparative neglect of the other sectors of the economy. Secondly, the eeonomy becomes unstable owing to

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6. Leibenstein, Harvey—*Economic Backwardness and Economic Growth,* 1950, p. 56.
7. Clark, Colin, *Conditions of Economic Progress,* 1957, pp. 618–619.
8. Mukherjee, M., *Papers on National Income and Allied Topics,* ed. Dr. V.K.R.V. Rao, 1962.

frequent changes in foreign exchange earnings caused by fluctuations in the international prices of the export commodities. That is, the national income of these countries is highly susceptible to fluctuations resulting from varying trends in the foreign markets for their products. Thirdly, it is pointed out that of late there has been going on a secular deterioration in the terms of trade of primary producing countries, so that the richer developed countries are benefiting at the expense of the poor under-developed countries. Fourthly, the export-orientation of such economies has stepped up their marginal propensity to import.

(viii) **Rapid Population Growth and Disguised Unemployment.** The diversity among under-developed economies is perhaps nowhere so much in evidence as in respect of the facts of their population as regards its size, density and growth. While we have examples of India and China with their teeming millions and galloping rates of growth, there are the Latin American countries which are very sparsely populated and whose total population in some cases numbers less than the single metropolitan cities in India and China. In several newly emerging countries of Africa too, and in some of the Middle Eastern countries, the size of their population cannot be regarded as excessive considering their large expanse. The South-east and Eastern Asia, on the other hand, have swarming populations.

However, there appears to be a common feature, namely, a rapid rate **of population increase.** This rate has been rising still more in recent years, thanks to the advances in medical sciences which have greatly reduced the mortality due to epidemics and diseases. While the death-rate has thus fallen phenomenally, birth-rate does not yet show any significant decline, so that the natural survival rates has become much larger. In countries like India, Pakistan and Burma, a veritable population-explosion is feared.

The great relevance of this important trend consists in this that it sets at nought all attempts at development inasmuch as the increased output is swallowed up by the increased population.

One important consequence of this rapid rate of population growth is that it throws more and more people on land to eke out their living from agriculture, since alternative occupations do not simultaneously develop and thus are not there to absorb the increasing numbers seeking gainful employment. The resultant pressure of population on land thus gives rise to what has been called **"disguised unemployment."** Low land-labour and capital-labour ratios must result in under-employment and disguised unemployment in agriculture. It means that there are more persons engaged in agriculture than are actually needed, so that the addition of such persons does not add to land's productivity; or putting it alternatively, given the technique and organisation, even if some of the persons are withdrawn from land, no fall in production will follow from such withdrawal.

(ix) **Under-utilisation of Natural Resources.** The natural resources in an under-developed economy are either unutilised or under-utilised. Generally speaking, under-developed countries are not deficient in land, water, minerals, forest or power resources though they be untapped. In other words, these constitute only potential resources. The main problem in their case is that such resources have not been fully and properly utilised due to various difficulties, such as their inaccessibility, shortage of capital, primitive techniques, and the small size of the market. This means that they have the potentialities for development but the level and character of their economic performance is too poor to take them forward.

(x) **Economic Backwardness of the People.** The people in under-developed countries are economically backward, that is, the quality of the people as productive agents is low. Instead of acquiring the greatest possible control over their physical environment, the people have struck a balance with nature at an elementary level. They have been relatively unsuccessful in solving the economic problem of man's conquest of his material environment. Particular manifestations of this are low labour efficiency, factor immobility, limited specialization in occupations and in trades, and a lack of entrepreneurship, economic ignorance, and a value structure and social structure that minimize the incentives of economic change.

(xi) **Poor Consumption Pattern.** The low level of earnings in the under-developed countries is reflected in their low level of living. The bulk (nearly 60 per cent) of their income is spent on necessaries of life, particularly food consisting mostly of cereals and devoid of nourishing items like fruits, meat, eggs, milk, *etc.* They are too poor to afford comforts and luxuries. The proportion of expenditure on housing and clothing is also very small. General poverty is also reflected in the very low standards of consumption of industrial goods and services.

(xii) **Peculiar Demographic and Social Characteristics.** There are certain demographic and social characteristics typical of the under-developed countries. Leaving a few under-populated and under-developed countries, the density of population is very high considering the resources and employment opportunities available. There is a very high proportion of the population in the age-group 0–15, and a lower proportion in the working group 20–60 years. Average expectation of life is low and infant mortality is very high.

Summing up. The socio-economic characteristics of under-developed countries have been comprehensively summarised thus: "Low aggregate and per capita incomes, limited availability of land, natural and capital resources per head; hence low productivity of labour which explains the low earnings of workers, the meagreness of savings and capital formation; the dependence of the major part of the population on agriculture and the extractive industries for earning a living, poor yield of agriculture per capita as well as per unit of land; great disparity in the distribution of income and wealth, concentration of large rental incomes in the hands of a few property owners; low levels of consumption expenditure and predominance of the outlay on food items; very unsatisfactory housing conditions and negligible spending on the ordinary comforts of life; great density of population and high rates of growth; high infant mortality rate, uneconomic distribution of population in the different age groups, heavy dependency load, concentration of population in urban centres; low standards of literacy, inadequate medical facilities, poor health standards and short expectation of life—all these are the common economic and social characteristics of the poor and backward countries of the world today." [9]

A very apt and easily understandable description of an under-developed country is given by Paul Hoffman thus: "Every one knows an under-developed country when he sees one. It is a country characterised by powerty, with beggars in the cities and villages eking out a bare subsistence in the rural areas. It is a country lacking in factories of its own usually with inadequate power and light. It usually has insufficient roads and rail-roads, insufficient government services, poor communications. It has few hospitals and few institutions of higher learning. Most of its people cannot read and write. In spite of the generally prevailing poverty of the people, it may have isolated islands of wealth with a few persons living in luxury. Its banking system is poor, small loans have to be obtained from money-lenders who are little better than extortionists. Among the striking characteristics of an under-developed country is that its exports to other countries usually consist almost entirely of raw materials, ores or fruits or some staple product with possibly a small admixture of luxury handicrafts" [10]

DUALISM AND ECONOMIC UNDER-DEVELOPMENT

Dualism is a major characteristic of an under-developed economy. Dualism refers to that condition of a country when two sectors (i.e. advanced or modern sector and the backward or traditional sector) exist side by side. For instance, we have modern industries and the old cottage industries working side by side as well as modern farming and medieval farming being practised at the same time. In other words, in an under-developed country, there is the bullock-cart economy and modern transport operating at the same time. Usually, modernisation is confined to the trade sector mainly organised, managed and financed by the foreign capitalist. Along with this advanced sector, there is a very large indigenous sector following traditional modes of production and distribution.

Types. In technical language, it may be called **Technological Dualism** as Benjamin Higgins mentions in his book **Economic Development.** Advanced sector is capital-intensive and the backward sector is labour-intensive.

There is also **Social Dualism** mentioned by J. H. Bocke in his book *Economics and Economic Policy of Dual Society.* The Society in under-developed countries is split into two parts, the upper and lower. The upper strata of society are influenced by modern ways of living and thinking, not tied by customs, enterprising and pursuing profits and having unlimited wants, whereas the lower strata are conservative, custom-ridden and follow the traditional modes of business and having limited wants, high preference for leisure and lacking in enterprise. In the under-developed sector, increase in wages leads to leisure and absenteeism in industry, and prices do not affect farming which is customary, Agriculture, in short is not commercialised.

There are people, however, who would not accept such sweeping generalisations. To some extent they apply to certain sections of western society too. Rather, it has been amply demonstrated that in under-developed countries too, there are progressive elements in which workers, by and large, respond to increase in wages and farmers to increased prices. For instance, it has been shown that producers of rubber in Malaya and rice farmers in Burma responded to the continously growing world demand for, and rising prices of, their products. It is the opportunity and the existence of infra structural facilities which matter. The fact is that in the under-developed economies, people would respond in the same way to opportunities available for increasing income as in the advanced countries.

There is another type of dualism, viz., **financial dualism**- modern banking institutions existing side by side with indigenous banking. This type has been discussed by H. Myint in his books. *The Economics of Developing Countries.* There exist a large unorganised financial market and a small organised financial market working in isolation with one another.

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9. **Bright Singh, D.**—*Economics of Development,* 1966, p. 26.

10. Quoted by Stephen Erke in *Economic for Development,* p. 16.